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ROLE OF TRANSNATIONAL CORPORATIONS IN SERVICES, INCLUDING TRANSBORDER DATA FLOWS: ROLE OF TRANSNATIONAL BANKS

Transnational banks and external indebtedness

Report of the Secretary-General

SUMMARY

There is a close correlation between the transnationality of banks and the international debt problem. The key players are the 25 large transnational banks with far-flung networks of branches, subsidiaries and affiliates, as well as large holdings of foreign assets and deposits. These banks account for well over 80 per cent of bank loans to developing countries.

From the onset of the debt crisis in 1982 through 1988, transnational banks made some contribution to debt reduction and/or cash-flow relief. This contribution has taken several forms: negotiated interest reduction, rescheduling of principal repayments, informal acceptance of interest arrears and debt conversions through cash buy-backs, debt/equity, debt-for-nature and other forms of swaps.

These efforts culminated in some reduction of commercial bank claims on 17 major debtor countries; but the claims in 1988 were $56 billion more than in 1982. Debt service as a proportion of exports of goods and services continues to be high, exceeding 40 per cent in some cases.

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Against this background, the Brady plan announced in March 1989 envisaged a number of measures aimed explicitly at a reduction of debt.

Given the amount of official financial resources so far committed in support of the Brady plan and the nature of the instruments through which the plan is to be implemented, its anticipated impact on debt reduction is likely to be small in relation to debtor countries' needs, interpreted in terms of the investment gap, or a reasonable interest/export ratio or a reduction in the absolute amount of debt-service payments.

Mexico, the Philippines and Costa Rica are the three countries that, so far, have reached agreements with creditor banks under the Brady plan. A review of these agreements appears to support the above conclusion.

In the light of this analysis, the present report suggests some additional measures that could be taken to reduce the burden of debt/debt service. These relate to the discretion given to transnational banks in choosing between debt reduction and new money options, flexibility in the use of official resources by the debtor countries for the purpose of debt reduction, the extent of voluntariness of the participation of commercial banks in debt reduction deals, the need to determine the extent of reduction required for different countries by an international financial institution, reforms in accounting, tax and regulatory provisions by creditor countries, measures to expand the scope of debt/equity conversions by debtor as well as creditor countries, ways to reduce capital flight from debtor countries and the creation of a new institutional arrangement to expedite debt-reduction negotiations.

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INTRODUCTION

1. At its fifteenth session, the Commission on Transnational Corporations adopted a resolution requesting a report on the present and potential activities of transnational banks related to the external indebtedness of developing countries and certain other countries with serious debt-servicing problems, taking into account the recent proposals that emphasize, inter alia, reduction of the stock and service of commercial debt. 1/ The present report, which supplements and updates the report submitted to the Commission at its fifteenth session, 2/ is in response to that request.

I. TRANSNATIONALITY OF BANKS AND THE DEBT PROBLEM

2. In the context of the debt problem, the key players are the 25 large transnational banks with far-flung networks of branches and subsidiaries around the world and tens of billions of foreign loans on their books. In the 1970s, larger transnational banks took the lead in managing and placing syndicated loans for developing countries with some participation of smaller banks.

3. These banks account for the mobilization of well over 80 per cent of bank loans to developing countries. Table 1 illustrates the degree of their transnationality. A disaggregation shows that the foreign office loans of the nine banks that hold 78 per cent of total United States bank exposure to the four large debtor countries (Argentina, Brazil, Mexico and Venezuela) account for 40 per cent of total loans, and foreign office deposits account for 56 per cent of total deposits. For the other nine banks (accounting for 17 per cent of total United States bank exposure to those four countries), foreign office loans account for 16 per cent of total loans, and foreign office deposits equal 20 per cent of total deposits. Available data suggest that the four big clearing banks have 30-35 per cent of the United Kingdom banks' claims on developing countries. The three big banks from the Federal Republic of Germany, Deutsche Bank, Dresdner Bank and Commerzbank, account for 50 per cent of loan exposure of banks from that country to developing countries.

4. Transnational banks dominate the advisory committees that negotiate loan restructuring agreements with the debtor countries on behalf of the entire banking community. The link between transnational banks and the debt problem is thus obvious.

Table 1. Transnationality of 25 banks with a major role in organizing syndicated credit

Rank a/	Bank	Country	Share of assets outside home country b/ (Percentage)	Share of deposits outside home country b/ (Percentage)	Foreign networks c/ (Number)
1	Citicorp	USA	46.8	53.0	240
2	Chase Manhattan	USA	43.2	45.0	107
3	Bank America Corp.	USA	35.8	24.0	184
4	J. P. Morgan & Co. Inc.	USA	47.9	62.0	85
5	Manufacturers Hanover	USA	33.5	45.0	67
6	National Westminster	United Kingdom	58.4	63.5	30
7	Lloyds Bank Ltd.	United Kingdom	46.0	50.8	12
8	Bank of Montreal	Canada	--	--	--
9	Bank of Tokyo Ltd.	Japan	--	63.1	101
10	Bankers Trust N.Y. Corp.	USA	--	--	--
11	Deutsche Bank	Germany, Federal Republic of	--	--	67
12	Royal Bank of Canada	Canada	36.3	40.7	121
13	West Deutsche L.B.	Germany, Federal Republic of	--	--	13
14	Chemical N.Y. Corp.	USA	--	--	--
15	Dresdner Bank	Germany, Federal Republic of	14.0	--	83

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Table 1 (continued)

Rank a/	Bank	Country	Share of assets outside home country b/ (Percentage)	Share of deposits outside home country b/ (Percentage)	Foreign networks c/ (Number)
16	Barclays Bank	United Kingdom	31.5	31.1	187
17	Midland Bank Group	United Kingdom	58.8	58.2	69
18	Canadian Imperial Bank of Commerce	Canada	--	--	--
19	Credit Lyonnais	France	29.6	29.2	102
20	Toronto Dominion Bank	Canada	--	--	--
21	Commerzbank A.G.	Germany, Federal Republic of	--	--	58
22	Bank of Nova Scotia	Canada	--	--	--
23	Industrial Bank of Japan	Japan	--	--	38
24	Banque Nationale de Paris	France	--	35.4	128
25	Long Term Credit Bank	Japan	--	--	28

Sources: Based on UNCTC/ECLAC Joint Unit on Transnational Corporations, Transnational Bank Behaviour and the International Debt Crisis (forthcoming), table 9, and United Nations Centre on Transnational Corporations, Transnational Corporations in World Development: Trends and Prospects (United Nations Publication, Sales No. E.88.II.A.7), annex table B.2.

a/ Ranked by the amount of credit organized during the period 1976-1982.

b/ Data for 1986.

c/ 1985 figures. Includes subsidiaries, affiliates, branches, representative offices and agencies. The number of entities may not be complete because subsidiaries and/or affiliates of foreign subsidiaries are not counted.

II. THE PAST ROLE OF TRANSNATIONAL BANKS

5. The announcement of the Brady plan in March 1989 marks a watershed in the perception of the role of transnational banks in managing the international debt problem. The emphasis has shifted from debt maintenance to debt reduction. The policy no longer seeks to maintain the debt and the stream of payments from troubled debtor countries and to avoid permanent losses for lenders; the new policy instead seeks to reduce the commercial bank debts of troubled debtors and reduce the stream of debt-servicing payments from troubled debtor countries to commercial banks, which are expected to absorb some permanent losses on the face value of their debt. This chapter briefly describes the role of transnational banks in the management of the debt problem during the period beginning from the onset of debt crisis in 1982 through 1988.

A. Highly indebted countries

6. While outstanding debt had risen sharply during most of the 1980s, actual (as opposed to contractual) amortization and interest payments have not (see tables 2 and 3). Amortization (all debts) for the 15 heavily indebted countries reached $29.4 billion in 1982, then fluctuated between $17 billion and $24 billion through 1988. Actual interest payments peaked at $44.3 billion in 1984, subsequently declined to $31 billion in 1987 and rose again to $38.7 billion in 1988. Seventy-five to 80 per cent of the total is estimated to consist of interests to commercial banks. Debt servicing as a percentage of exports was 52 per cent in 1982, then fluctuated between 40 per cent and 45 per cent for most of the rest of the decade.

7. The slight easing of the debt service ratio was partly a result of forces, such as a fall in the interest rate (leading to a reduction in interest liabilities against loans contracted on a floating rate basis) and the improved export performance of some indebted countries. To some extent, transnational banks also contributed, and their contribution assumed several forms:

(a) First, there has been a negotiated interest reduction. Banks have gradually accepted smaller interest spreads on restructured loans. The first Mexican rescheduling, for example, raised fee and interest charges by about one percentage point over the original loan terms. But subsequent loan restructurings have brought down average spreads for Mexico and other debtors to about thirteen/sixteenths of 1 per cent, and restructuring fees have been sharply reduced; 3/

(b) The second form of debt-service relief is the rescheduling of principal repayments. From 1983 to 1988, for example, commercial banks rescheduled some $380 billion in loans to 15 heavily indebted countries (this figure includes some double counting because some loans have been rescheduled more than once). Some $83 billion of bank debt was rescheduled in 1988, of which $61 billion was for Brazil; 4/

Table 2. Commercial bank claims on 17 highly indebted countries

(Billions of dollars)

Country	1982	1987	1988
Argentina	22.1	35.3	35.0
Bolivia	0.659	0.593	0.424
Brazil	56.0	81.0	75.9
Chile	10.4	12.9	11.0
Côte d'Ivoire	2.9	1.3	1.2
Colombia	5.5	6.6	6.9
Ecuador	4.0	5.0	4.9
Mexico	59.0	75.8	69.3
Morocco	3.6	5.6	5.0
Nigeria	7.0	10.7	8.9
Peru	5.2	5.1	4.6
Philippines	8.3	14.4	12.3
Uruguay	1.2	2.1	2.0
Venezuela	22.4	25.0	25.5
Yugoslavia	9.3	10.0	9.0
Subtotal	217.6	291.4	271.5
Hungary	6.4	12.4	11.5
Poland	13.4	12.2	10.5
TOTAL	237.4	316.0	293.5

Source: Bank for International Settlements, International Banking and Financial Market Developments, various issues.

Note: Banks are those included in the Bank for International Settlements' international banking statistics. Data are for year-end and exclude claims guaranteed by banks' own Governments or multilateral institutions.

Table 3. Debt and debt servicing: 15 heavily indebted middle-income countries

(Billions of dollars or percentage)

Item	Average 1970-1979	Average 1979-1981	1982	1983	1984	1985	1986	1987	1988
Total debt outstanding (Billions of dollars) a/	96.9	275.7	381.4	397.4	409.6	422.7	447.4	482.7	477.4
Short-term (per cent of total)	10.3	18.7	19.8	14.3	13.3	8.2	7.5	7.8	8.0
Total debt outstanding as per cent of exports of goods and services	160.0	185.0	268.3	291.9	271.3	288.3	348.7	338.7	299.8
Amortization (Billions of dollars) b/	10.8	24.4	29.4	16.7	18.7	17.7	21.7	19.7	24.3
Interest (Billions of dollars) b/	6.3	26.7	44.3	40.2	44.3	41.9	36.4	31.0	38.7
Interest as per cent of exports of goods and services	10.3	17.7	31.2	29.5	29.4	28.6	28.3	21.7	24.3
Interest accruals c/	5.9	26.8	45.5	41.3	46.7	44.2	39.8	38.1	42.4
Accruals as per cent of exports of goods and services	8.9	17.6	32.0	30.4	31.0	30.2	31.0	26.7	26.6
Debt service as per cent of exports of goods and services	27.3	35.7	51.9	41.8	40.7	45.3	35.5	39.6	
Memorandum item: cash flow impact of rescheduling d/	0.1	0.3	1.8	21.1	28.4	29.1	34.1	44.6	38.4
Debt owed to (Billions of dollars):									
Commercial banks e/	--	--	287.0	304.4	301.4	309.5	320.9	326.1	327.1
World Bank f/	5.2	10.5	13.9	16.4	16.7	22.9	31.8	41.8	39.8
Other official lenders g/	15.7	31.5	38.8	46.9	54.5	62.9	70.7	83.9	92.2
Use of IMF resources h/	1.3	3.1	5.9	11.8	14.2	17.7	19.5	21.2	19.4
Use of IMF resources as per cent of quotas	34.5	44.9	84.5	125.9	160.0	177.7	176.2	165.0	153.6
Ratio of gross reserves to imports i/	32.3	25.8	13.5	17.7	25.4	27.1	23.0	24.6	19.6

Source: Group of Ten, The Role of the IMF and the World Bank in the Context of the Debt Strategy: A Report to the Ministers and Governors by the Group of Deputies (June 1989).

a/ Excluding use of IMF and IMF-administered resources.

b/ Payments actually made (i.e., after reschedulings and arrears). Exceptional financing items, including accumulation of arrears and impact of rescheduling, should be added to arrive at indication of the ex ante scheduled debt-service burden.

c/ Scheduled interest payments.

d/ Allocates rescheduling of future payments due to year in which rescheduled payment was originally due.

e/ Cross-border bank claims outstanding, as reported in International Banking Statistics.

f/ Book value of liabilities outstanding at IBRD and IDA.

g/ Excluding use of IMF resources.

h/ Net credit from IMF, including outstandings under General Resources Accounts, Trust Fund, SAF and ESAF.

i/ Official holdings of gold are valued at SDR 36 an ounce, ratio to imports of goods and services.

(c) An important form of informal debt-service relief is interest arrears. The gap between payments due under contractual obligations and what debtors have actually been able to pay has been covered by mounting interest arrears. Fifteen highly indebted countries paid bank creditors $16 billion less in interest than scheduled from 1983 through 1988. Other debtors have also run large interest arrears. Arrears as a percentage of total interest due have been rising. In 1989, interest arrears owed to commercial banks by 15 heavily indebted countries rose to $10 billion. For commercial banks, this means in effect having $100 billion worth of non-performing loans on their books (assuming average interest rates of 10 per cent), or about one third of their total loan exposure to these countries. Little wonder banks have raised their loan loss reserves. It should be emphasized that the rescheduling of principal repayments and interest arrears eases the cash-flow constraint on debtors, but this is not a form of permanent relief. Eventually, debtors are either required to become current in payments or interest arrears are added to principal, that is, are capitalized. In the latter case, the debtor has to pay interest on that amount as on any other debt. And arrearage can reduce the benefit of new loans to the debtor. For example, more than $3 billion of the $5.2 billion Brazil received under the 1988 agreement with banks was used to pay off accumulated interest arrears;

(d) Another form of debt reduction is by way of debt conversions through cash buy-backs, debt/equity, debt-for-nature and other forms of swaps. The scope of this instrument is discussed further below.

B. The experience of Eastern Europe

8. The flow of medium- and long-term credit and bond financing to Eastern Europe declined sharply in 1982 and 1983, then recovered in 1984-1985. Bulgaria, the German Democratic Republic and Hungary have been the biggest borrowers other than the Soviet Union. The stock of the German Democratic Republic's debt at the end of 1988 was over $20 billion. Hungary took publicized credits of more than one billion dollars every year from 1984 to 1988. The Soviet Union, which had borrowed negligible amounts in the publicized market from 1980 through 1983, has steadily increased its borrowing since, to more than $2.6 billion in various forms in 1988. Poland and Romania, on the other hand, have been virtually absent from the market. Romania has paid off virtually its entire Western bank debt and, by the end of 1988, had deposits of $809 million, $51 million more than it owed. 5/

9. Despite the increase in borrowing, spreads have come down since 1983, and maturities have lengthened, indicating that East European countries are finding favour with lenders. By 1988, the average spread paid by the group for new loans was marginally above the London Inter-Bank Offered Rate (LIBOR). (Syndication fees are rarely made public; it is therefore not possible to know whether these borrowers are paying bigger up-front fees to compensate syndication managers for the narrow spreads.) Maturities on syndicated loans have also lengthened from an average 4 1/2 years in 1983 to 8 1/2 years in 1988. In 1987, Czechoslovakia and the Soviet Union were able to borrow for 8 years (with 6 years' grace) and pay only one eighth of a per cent over LIBOR. 6/

10. In 1987, Poland reached an agreement with its 550 foreign bank creditors to reschedule some $8 billion in debt falling due through 1993. The loans are rescheduled for 15 years, with little repayment in the first part of this period, and carry an interest rate of thirteen sixteenths over LIBOR. Revolving trade credit facilities, amounting to half the annual interest due from Poland and arranged in 1983 and 1984, were renewed for two years. Poland is seeking substantial official loans from Western Europe and the United States as well as the international financial institutions. It is not yet clear whether it will seek additional concessions from its bank creditors.

11. Poland has rescheduled all debt to official Western lenders and most of its interest due through 1988. Thanks to the reschedulings, and some improvement in export performance, Poland's debt-service ratio has improved since the beginning of the decade but is still bad. In 1988, total interest and amortization on medium- and long-term debt was about 68 per cent of exports.

12. Hungary has increased its recourse to medium- and long-term financing from the West significantly since 1983. Its total debt has increased from $12 billion in 1981 to $17.7 billion at the end of 1987, of which 63 per cent is estimated as unguaranteed bank debt, making Hungary particularly vulnerable to any rise in interest rates. Hungary's debt-service ratio has deteriorated and in 1988 was approximately 52 per cent.

C. African countries

13. Most African countries are faced with a critical debt problem. Though most of the debt is owed to official creditors, some of the countries have sizeable debts to transnational banks (see table 4).

14. Banks have taken very little initiative in solving Africa's commercial debt problem. A few African countries received some concessions on grace, maturity and interest rates under London Club rescheduling arrangements. Some countries have undertaken substantial debt-equity conversions ($100 million each in Nigeria and Zambia), and others are in the process of developing plans to do so. The underdeveloped capital markets severely limit the potential of debt-equity conversions in Africa. Intergovernmental agencies and private voluntary organizations have proposed debt-nature and debt-development swaps under which banks could claim tax deductions for donating debt and such donations can be used for implementing child welfare, rural development and conservation projects. About $800,000 of Sudan's debt to Midland Bank has been converted by the United Nations Children's Fund (UNICEF).

15. The overall impact of these measures brought little relief to African countries. Their ratio of debt service to exports at the end of 1987 was above that of 1982; for the least developed countries in Africa, it increased from 12 per cent to 19 per cent over this period. 7/

Table 4. Debt positions of African countries, 1988

(Billions of dollars)

Country	Total debt	Long-term debt to all private creditors	Long-term debt to commercial banks
Algeria	24.85	17.73	3.16
Benin	1.06	0.36	0.16
Botswana	0.50	0.03	0.00
Burkina Faso	0.87	0.03	---
Burundi	0.79	0.02	0.02
Cameroon	4.23	0.61	0.07
Cape Verde	0.13	---	0.00
Central African Republic	0.67	0.02	0.00
Chad	0.35	0.04	---
Comoros	0.20	---	---
Congo	4.76	2.09	1.59
Côte d'Ivoire	14.12	3.28	3.18
Djibouti	0.18	---	---
Egypt	49.97	5.00	0.26
Equatorial Guinea	0.20	0.01	0.00
Ethiopia	2.98	0.46	0.19
Gabon	2.66	0.80	0.79
Gambia	0.33	0.03	0.02
Ghana	3.10	0.23	0.06
Guinea	2.56	0.20	0.06
Guinea-Bissau	0.42	0.09	---
Kenya	5.89	0.67	0.10
Lesotho	0.28	0.02	0.00
Liberia	1.63	0.20	0.18
Madagascar	3.60	0.31	0.17
Malawi	1.35	0.05	0.04
Mali	2.07	0.03	0.01
Mauritania	2.08	0.11	0.01
Mauritius	0.86	0.12	0.03
Morocco	19.92	4.56	3.19
Mozambique	4.41	0.75	0.37
Niger	1.74	0.10	---
Nigeria	30.72	17.65	6.39
Rwanda	0.63	0.01	0.00
Sao Tome and Principe	0.10	---	0.00
Senegal	3.62	0.18	0.08
Seychelles	0.16	0.03	0.03
Sierra Leone	0.73	0.10	0.02
Somalia	2.04	0.03	0.00
Sudan	11.85	1.43	1.43
Swaziland	0.26	0.01	---
Tanzania	4.73	0.27	0.11
Togo	1.21	0.05	0.05
Tunisia	6.67	1.50	0.40
Uganda	1.93	0.11	0.04
Zaire	8.48	0.70	0.56
Zambia	6.50	0.52	0.07
Zimbabwe	2.66	1.01	0.25

Source: World Bank, World Debt Tables, 1989-1990 (Washington D.C., 1989).

III. NEW ROLE OF TRANSNATIONAL BANKS

16. This brief review clearly shows that the role played by transnational banks through the end of 1988 brought about practically no respite for debtor countries. It will be recalled that although commercial bank claims on 17 major debtor countries (including Hungary and Poland) declined by over $20 billion between 1987 and 1988, the claims in 1988 were $56 billion more than in 1982 (table 2). Debt service as a proportion of exports of goods and services in 1988 for 15 major debtor countries, excluding Hungary and Poland, was nearly 40 per cent (table 3) and was much higher for the latter two countries. The net transfer of resources from the 15 major indebted countries to the rest of the world has varied between 3-5 per cent of gross national product (GNP); this has been an important factor leading to a decline in investment, per capita consumption and expenditure on vital social services, such as health and education. 8/

17. It is against this background that the Brady plan was announced in March 1989 with an explicit recognition of the role of commercial banks in reducing stock and/or service of debt. It should be noted that a certain degree of reduction was also implicit in the earlier Japanese and French proposals, 9/ but the Brady plan is distinguished by its formal acceptance by creditor countries and the fact that a few agreements have already been reached between the banks and debtor countries within the framework of this agreement.

A. Elements in the Brady plan concerning the role of transnational banks

18. The Brady plan envisages a number of measures to be adopted by the debtor countries, lender banks, creditor countries, as well as the International Monetary Fund (IMF) and the World Bank. The elements concerning the role of banks in the reduction of debt stock and service are briefly summarized below: 10/

(a) Waiver of the sharing and negative pledge clause for a period of three years;

(b) Official financial support in the implementation of debt/debt service reduction via debt buy-backs, the exchange of old debt for new collateralized bonds at a discount or the exchange of old debt for new par value bonds with reduced interest rates;

(c) Maintenance of viable debt-equity swap programmes;

(d) Provision of new money by banks;

(e) Reduction by creditor countries' Governments of regulatory, accounting and tax impediments to debt reduction;

(f) Délinking of disbursements by the international financial institutions from prior agreements with banks.

B. The anticipated impact of the Brady plan

19. The Brady plan undoubtedly marks a major step forward in the management of the debt problem in that it explicitly enjoins the transnational banks to accept a reduction in debt. However, there are legitimate concerns about the extent to which the plan will actually contribute to a solution of the debt problem. A recent publication of the World Bank notes that while the initiative has been welcomed as an important and desirable evolution of the debt strategy by most participants in the international arena, a number of important questions have been raised about it. 11/

20. One of those questions concerns the financial support behind the plan. The IMF and the World Bank together are expected to provide $20 billion to $25 billion, and Japan has agreed to provide another $10 billion. This financial support is to be made available at non-concessional interest, and hence actual relief will be less than the reduction in debt-service payments to banks. According to World Economic Survey, 1989, under the assumptions of secondary market prices of debt at 36 cents per dollar, an interest rate of 10 per cent on commercial bank debt and $29 billion in new official loans provided for buy-backs (as distinguished from loans that would be available to debtor countries anyway) carrying an interest rate of 8 per cent, the net reduction of foreign interest payments would be about 13.5 per cent for the 15 heavily indebted countries. 12/ The United Nations Conference on Trade and Development (UNCTAD) estimates that assuming an availability of $30 billion for reduction of debt burdens, if one half of the amount is used to exchange debt at a discount of 40 per cent for an alternative financial instrument whose repayment is guaranteed by a 20-year zero-coupon bond with an interest rate of 8.3 per cent, and the other half provides a two-year rolling guarantee on the interest payments of the alternative instrument, the reduction of principal for the heavily indebted countries would amount to less than 20 per cent of their medium- and long-term debt to banks, and interest payments would fall by about 15 per cent of their current obligations. 13/

21. The scope for reduction of debt through various forms of conversion is also rather limited. There has, no doubt, been an upsurge in the use of this instrument over the past two years. The IMF estimates that the total amount of debt converted since 1984 into something other than foreign bank claims is about $16.5 billion, with half of that taking place in 1988 (see table 5). The Bank for International Settlements estimates that if one includes debt-for-debt swaps (such as Mexico's exchange of $3.671 billion of medium-term bank debt for $2.556 billion in 20-year collateralized bonds and Brazilian "exit bonds" included in Brazil's last rescheduling), the total amount of debt converted is over $20 billion. 14/ The World Bank puts the total amount of conversion even higher, in 1988 alone at more than $22 billion of which it estimates that debt/equity swaps accounted for 42 per cent. 15/ The Bank makes a rough calculation that these conversions yielded debt reductions in the order of $8.5 billion. Argentina, Brazil, Chile and Mexico account for 90 per cent of the conversions so far, but other countries (including Costa Rica, Ecuador, Honduras, Jamaica, Nigeria, the Philippines, Uruguay and Venezuela) have also had active programmes. Quite clearly, debt-equity swaps, while making a noteworthy contribution, cannot resolve the debt problem. Under the best of circumstances, the likely volume of swaps would be small in relation to

the total size of debt which is many times the total market capitalization of stocks in the major debtor countries (see table 6). It should also be noted that the World Bank's projections indicate that total debt conversions in 1989 would be about 60 per cent of the amount of conversions in 1988. 16/

Table 5. Debt conversions, 1984-1988 a/

(Millions of dollars)

Country	1984	1985	1986	1987	1988
Argentina	31 b/	469	--	--	1 362
Brazil	731	537	176	290	1 964 c/
Chile	--	323	974	1 983	2 606
Mexico	--	--	413	1 741	1 356 d/
Others e/	--	--	22	538	929
TOTAL	762	1 329	1 585	4 552	8 217 f/

Source: Group of Ten, The Role of the IMF and the World Bank in the Context of the Debt Strategy: A Report to the Ministers and Governors by the Group of Deputies (June 1989).

a/ Face value of debt converted under officially recognized operational schemes.

b/ Annual breakdown estimated.

c/ January to October 1988.

d/ Does not include the exchange of $3,671 million of medium-term bank debt for $2,556 million in 20-year collateralized new Mexican bonds or $6-8 billion in prepayments since the August 1987 signing of the Ficorca restructuring.

e/ Costa Rica, Ecuador, Honduras, Jamaica, the Philippines, Uruguay, Venezuela.

f/ Figures do not include the exchange of $64.4 million of Bolivian debt to banks for $7.1 million in 25-year collateralized bonds as part of a buy-back scheme.

Table 6. Selected developing country debtors: commercial bank claims and stock market capitalization

(Billions of dollars)

Country	Commercial bank claims (End 1988)	Stock market capitalization (End 1986)
Argentina	35.0	1.6
Brazil	75.9	44.0
Chile	11.0	2.7
Mexico	69.3	6.0
Nigeria	8.9	2.5
Philippines	12.3	2.0

Source: Table 1 and "The world needs more stock markets", The Wall Street Journal, 17 March 1987.

22. The question of how much debt relief is needed is difficult to answer with any precision. Some alternative approaches are discussed below to give an indication of the order of magnitude.

23. The key to sustainable economic growth and rising standards of living in the debtor countries is increased investment. Thus one way of determining how much debt relief is needed is to examine the gap between current levels of investment and the level that would be needed to sustain a growth rate of 4-6 per cent per year.

24. Developing countries would need an investment/gross domestic product (GDP) ratio of 20-25 per cent to sustain growth at that level. Since the beginning of the debt crisis, investment/GDP levels in 15 heavily indebted countries have fallen to around 17 per cent of stagnant or declining GNP. By contrast, Asian newly industrializing countries/territories have had investment rates of around 27 per cent of their rapidly growing economies.

25. Assuming that debtor countries need an investment ratio of approximately 25 per cent to grow and to recover from a decade of low investment, 14 of the 15 heavily indebted countries (excluding Yugoslavia) had an investment shortfall of more than $50 billion in 1987. Of course, the total investment shortfall is much larger if all debtor countries experiencing debt servicing problems are included.

26. It is recognized that debt-related transfers are not the only cause of depressed investment levels, but there is a close correlation. In the present situation of stagnant or declining per capita income, it would be difficult to raise the domestic savings rate. Therefore, most of the investment gap has to be met by a transfer from the rest of the world. According to World Economic

Survey, 1989, the heavily indebted countries will certainly continue to transfer substantial resources to the rest of the world despite the debt reduction resulting from the Brady plan, given the resources being currently discussed for the plan. 17/ The investment gap of the magnitude indicated above obviously cannot be met.

27. An earlier UNCTAD study suggested the need for a reduction of the total debt of 15 heavily indebted countries to commercial banks by 30 per cent, which is equivalent to 36 per cent of their medium- and long-term debt to banks. It noted that even 40 per cent debt relief on all debt owed to commercial banks would not suffice to reverse financial outflows from those countries. 18/ The rise in interest rate since then has further increased the need for debt reduction.

28. According to estimates from the United Nations Centre on Transnational Corporations, if the interest due/export (distinguished from actual interest payment/export) ratio were to be reduced to 20 per cent at the end of three years for Argentina, Bolivia, Brazil, Ecuador, Mexico and Peru, the reduction of the volume on all debt would have to be of the order of $122 billion, under the assumptions of a 5 per cent per annum growth rate of exports and a 10 per cent interest rate. 19/ The amount is equivalent to 57 per cent of commercial bank claims on those countries.

29. Other studies suggest the need for an even higher reduction. For instance, one study estimates that if the debt service of Latin American countries were to be kept constant at the 1988 level, the required reduction in commercial medium-term and long-term debt over a period of two years would be 70 per cent. 20/

30. The Brady plan does not set a specific target for debt reduction, but the expectation has centred around 20 per cent. Quite clearly, its anticipated impact is inadequate to meet the debt reduction needs of debtor countries.

C. Country experiences

31. Mexico, the Philippines and Costa Rica are the three countries that have so far reached agreements with their creditor banks under the framework of the Brady plan. A brief review of these agreements further illustrates the inadequacy of the debt reduction measures stipulated under that plan.

1. Mexico

32. In June 1989, Mexico signed an agreement with its 15-bank advisory committee which envisaged a certain extent of debt/service reduction and new money for Mexico while giving creditor banks an enhanced asset. The agreement, which was reached after four months of protracted negotiations, is yet to be ratified by all of the country's creditor banks.

33. With regard to some $54 billion of commercial debt covered by the agreement, banks are offered four options: debt reduction, debt-service reduction, new money and interest recycling. Creditors may exchange any or all of their eligible claims

for either "collateralized floating rate discount bonds" or "collateralized fixed rate par bonds". The bonds will be denominated in a number of currencies. The conversion rate of existing debt for discount bonds will be 65 per cent of face value. Discount bonds will pay thirteen sixteenths over six-month LIBOR. Par bonds will be exchanged at par and carry a 6.25 per cent interest rate. Both will carry a 30-year maturity. Mexico commits to fully collateralize the principal of both bonds through the purchase of zero-coupon bonds and to guarantee interest for not less than 18 months and not more than 24 months, on a rolling basis. The amount of collateral required to secure the bonds is estimated to be $7 billion.

34. Both bonds are "exit bonds" in the sense that they excuse participating banks from any further restructuring exercises. The bonds will not count as part of the basis for any future demands for new money and will not be subject to any future restructuring.

35. Banks that do not convert any or all of their claims into discount or par bonds are asked to lend more money, an amount equal to 25 per cent of their exposure, spread over four years starting in 1989 (7 per cent in 1989, 6 per cent in the other three years). Interest paid by Mexico on existing debt may be recycled for this purpose. New loans will have an interest of thirteen sixteenths over LIBOR, 15 years' maturity and 7 years' grace.

36. Banks choosing the new money option will have a new additional Mexican asset on their books, and they will also have all of their old debt replaced with new debt. The purpose of this, presumably, is to allow Mexico to deal with "free riders", that is, banks that refuse to participate in any of the restructuring options. Giving all participating banks new pieces of paper (that is, new claims to replace the old) is intended to negate the sharing clauses contained in the old loan contracts. Mexico can thus discriminate in favour of participating banks, and banks that are receiving payment are no longer obliged to share with non-participating banks because the old syndicated loans have been superseded by new loans.

37. Quite apart from the fact that there are uncertainties as to Mexico's ability to mobilize the $7 billion required up front before any debt exchange takes place, the implementation of the deal will not make a dramatic difference. The actual result will, of course, depend on the options chosen by banks. Based on the assumptions that banks would choose an interest rate reduction on 60 per cent of the existing loans, a principal reduction on 20 per cent and new loans on 20 per cent, it is estimated there would be a reduction of debt of the order of $3.8 billion and of interest payments of the order of $1.5 billion out of an estimated $9.6 billion in 1989. Taking into account the fact that Mexico will have to contract new official loans, its overall debt stock is likely to remain unchanged during the next four years. 21/ Other estimations also indicate a debt reduction of similar magnitude. William R. Cline of the Institute for International Economies, Washington, D.C., estimated that the agreement would lead to a decline of Mexico's bank debt by $3.5 billion to $4 billion and its interest payment by $1 billion to $1.5 billion; Shafiqul Islam of the Council of Foreign Relations, New York, estimated a decline of interest payments by less than $1.5 billion. 22/ A preliminary assessment by the World Bank is a little more

optimistic; it is anticipated that the reduction of debt stock resulting from the agreement would be about $8 billion or 8 per cent of Mexico's total external debt. 23/

2. The Philippines

38. In August 1989, the Philippines negotiated an agreement with its creditor banks. With borrowings from the IMF and the World Bank and other resources, the Philippines expects to buy back a total of $1.3 billion of its $7.5 billion medium- and long-term bank debt (the remainder of its bank debt is in the form of short-term trade credits). The actual extent of debt reduction will, of course, depend on the prices at which the country can buy back its debt. Banks are expected to provide new credit of up to $1.2 billion against government bonds.

39. In the case of the Philippines, in contrast with that of Mexico, the relative emphasis has been greater on new money than on debt reduction. There was no pre-determined proportion of debt reduction. The overall debt reduction resulting from the Filipino agreement will be even less than the Mexican one.

3. Costa Rica

40. Banks have made major concessions to Costa Rica in the recent debt reduction agreement, albeit after long negotiations. Costa Rica will be allowed to buy back medium-term bank debt at a discount likely to be of the order of 80 per cent and $325 million in interest arrears on the same terms. The remaining base debt will be exchanged at par for a bond with an interest of 6.25 per cent and the remaining interest arrears will be exchanged for a 15-year bond paying an interest rate of thirteen sixteenths over LIBOR. Banks that tender at least 60 per cent of the base debt and arrears for a discounted buy-back get guarantees of one year's interest on the fixed rate bond and enhancements for three years' interest on the 15-year bonds. According to the President of Costa Rica, the agreement would reduce the country's commercial debt by about two thirds and its interest bill owed to commercial banks by the same proportion. 24/

41. However, Costa Rica's absolute volume of transnational bank debt is small (around 1 billion dollars at the end of 1988) compared to that of other heavily indebted countries. The extent of debt relief given to Costa Rica is unlikely to be available to other countries.

IV. OPTIONS FOR FURTHER ACTION

42. The preceding paragraphs amply demonstrate the inadequacy of the debt-reduction efforts implemented so far. The following paragraphs describe some additional measures that could be adopted to provide further stimulus to these efforts.

A. The choice between debt reduction and new money

43. The protracted negotiations over Mexico's debt have revealed several weaknesses in the Brady plan. The first is that having called for debt reduction as the solution to the debt problem, banks are being urged to lend more. The continued search for new money raises questions about how much relief is really being offered, creates uncertainty about burden sharing among the commercial creditors and blurs the policy objective.

44. There is no doubt that debtor countries may need new money to finance trade and new investment projects. Commercial banks willing to provide resources for such activities should be free to do so, but not at the expense of debt reduction. In other words, new money option should not be a substitute for measures intended to reduce debt.

B. The use of official resources

45. A second weakness of the plan relates to the use of official resources for debt reduction. Under the existing arrangements, up to 25 per cent of whatever a particular country is entitled to draw or borrow from a multilateral financial institution may be used for debt reduction - to finance debt buy-backs, collateral for debt-for-debt swaps, and so on. With this official committment in place, the debtor is to negotiate with commercial lenders the maximum debt relief they are prepared to volunteer. The limited enhancement for debt relief instruments available from official sources then becomes an argument for banks to limit the amount of debt reduction they will offer. The result of this process, as evidenced by the agreements concluded so far, is an inadequate debt-reduction agreement.

46. There are circumstances in which official funds could make a greater economic contribution to the economic recovery of debtors in debt-reduction schemes than by way of investment in new projects. Official lenders may feel that they have more control over the use of funds in direct lending (although that is arguable in the case of "programme lending" by the World Bank or balance-of-payments financing in a standard IMF stabilization programme), and that they will not have the leverage to guarantee that resources freed up through debt reduction will be put to productive use. But unless one assumes that this will indeed be the case, there is no point in engaging in the debt-reduction exercise to begin with. The critical policy question is: which method of deploying official resources will produce the biggest boost in debtor incomes over a period of years?

47. Debtor countries should, therefore, be given greater flexibility in the use of official funds for debt reduction, rather than being subject to an *a priori* limit of 25 per cent. The multilateral agencies could also stop segregating financial support for interest payments on the one hand and principal reduction on the other. Such segmentation puts a constraint on the debtor negotiators that may reduce overall the amount of debt reduction for a borrower. Moreover, official guarantees for debt reduction instruments could take the form of an escrow account in the IMF or the World Bank rather than a direct loan to the debtor country. The debtor would only have to pay a commitment fee, rather than interest on the full

loan, until such time as the guarantee is called, thus reducing its overall costs of collateralizing debt reduction.

C. The extent of voluntariness

48. An alternative solution would be to have both an increase in direct official lending and deep debt reductions by commercial lenders with minimum official enhancements. This would require more concerted efforts by Governments to persuade their banks to accept greater debt reductions. It would be perfectly reasonable for official lenders that are acting as insurers for debt-reduction swaps to insist on a minimum amount of debt reduction by banks before the official collateral would become available. Official lenders, for example, could have argued that a 35 per cent reduction in bank claims against Mexico exposed official guarantors to an unacceptable level of risk. Official support would be available only if banks agreed to a higher reduction. Governments have many regulatory and supervisory levers to persuade banks to "volunteer" for such terms. They can also make firm commitments that official loans will continue to flow to countries even if they fall into payment arrears to banks which are not co-operating.

D. The determination of debt reduction

49. The extent of debt reduction for any country under the present arrangements has been left essentially to negotiations between debtor countries and creditor banks. This brings about a great deal of complexity in the negotiating process.

50. Banks themselves fully recognize that many of their loans are not worth 100 cents on the dollar and never will be. Most banks have already faced this fact by establishing loan loss reserves that range in the United States from 30 per cent to 100 per cent of medium- and long-term loans to developing countries. Continental European banks appear to have reserves from 50-100 per cent of troubled developing country loans, and banks from the United Kingdom have reserves above 50 per cent. With such reserves in place, banks can take immediate substantial losses without any significant impact on earnings or on capital. Nevertheless, they try to minimize the reduction of losses in the negotiation process.

51. The extent of debt reduction required for each debtor could be pre-determined by the IMF and the World Bank, with the secondary market price as a reference point, modified by other considerations. 25/

E. Tax and regulatory review

52. The Brady plan has raised a number of complex tax and regulatory issues for banks. The specific issues vary from country to country but include such questions as when do losses have to be taken, and what will be the tax consequences; how will debt reduction bonds be valued on the banks' books; and how much public disclosure will be required.

53. The United States and Japan have already announced some steps to deal with their banks' complaints. The United States authorities have decided that banks can continue to carry troubled loans at 100 per cent of original face value even if, as in the case of Mexico for example, they swap existing debt for new obligations carrying either 35 per cent lower face value than the old loan or substantially lower interest rates. This has the effect of allowing banks to spread their losses over time, because losses will take the form of reduced income on the loans rather than loan write-offs. Nevertheless, the tax authorities will allow the debt exchange to be treated as an immediate loss for tax purposes, allowing banks to take their tax loss deduction immediately. It remains to be seen whether bank accountants will accept these principles.

54. Japanese authorities had been reluctant to let Japanese banks write off loans because of the tax-revenue implications. But they have now agreed to let Japanese banks get the tax benefits of any write-downs associated with the Mexican debt-reduction plan. It is unclear, however, over how many years the losses will have to be spread.

55. Such progress notwithstanding, a variety of differences in provisions concerning reserves, tax and accounting regulations among the major creditor countries have complicated the debt negotiating process since 1982. These regulatory differences reflect different customs, policy priorities and, to some extent, different approaches to the debt problem.

56. Loan loss reserves are fully tax-deductible in Canada, France, the Federal Republic of Germany, New Zealand and the United Kingdom but deductible only up to 1 per cent of loans outstanding in Japan and not at all in the United States (when the 1986 tax reform rules take full effect). United States banks get a tax deduction only when a loss is actually recognized, that is, when a loan is written off in whole or in part.

57. Canada requires specific reserves of 35-45 per cent against aggregate exposure to 38 countries. The Federal Republic of Germany, Switzerland and the United Kingdom have indicative reserve levels that, in practice, seem to amount to mandatory levels. Japan had stipulated average maximum reserves of 5 per cent against exposure to 39 countries but, in 1988, raised allowable provisioning levels to 10 per cent. United States regulators have required specific reserves for a limited number of countries with large interest arrears.

58. Accounting régimes also differ. Canada, the Federal Republic of Germany and the United Kingdom treat loan loss reserves as a reduction in assets; France, Japan and the United States treat them as an addition to capital (up to 14 per cent). This will change under the new Bank for International Settlements rules. The valuation of debt/debt and debt/equity swaps for reporting purposes also varies from country to country. Some countries permit or require banks to "mark to market", that is, to value the asset at some approximation of market price; others, most notably the United States, allow banks to carry even discounted swap assets at original value under certain circumstances. The United Kingdom requires new instruments to be carried at original value unless a bank can prove that the loan

is ultimately unrecoverable. This may limit the attraction of debt reduction swaps for United Kingdom banks.

59. Tax benefits accruing from debt-reduction transactions may be limited by a lack of qualified taxable income against which to offset the loss in a given year. Under United States tax law, for example, foreign loan losses could until a recent ruling only be offset against United States taxes owed on other foreign source income. In the future, tax benefits will be calculated on the basis of the foreign/domestic loan portfolio (rather than a distribution of income). But with shrinking foreign loan portfolios and many non-performing loans, some banks may have little income against which to apply a tax deduction. Banks in other countries face varying restrictions. Rules for tax loss carry-forward and carry-back also vary from country to country and from one type of transaction to another.

60. Regulatory differences make it difficult for debtor country negotiators to structure a debt reduction package that has a similar impact on all creditor banks. This creates formidable difficulties in securing their consensus on any package. All creditor countries could review their regulatory and taxation-related measures and eliminate bottle-necks in a co-ordinated manner expeditiously. 22/

61. One area where quick and concerted action by regulators in the major creditor countries would be helpful concerns capital adequacy. Members of the Bank for International Settlements have adopted a common standard for bank capital adequacy. Banks will have to maintain capital equal to 8 per cent of total "risk weighted" assets. The agreed "risk weighting" formula allows regulators to discriminate among types of assets (loans mostly) in calculating how much total capital a bank must have. Under the formula, a loan to the bank's own Government carries zero risk and hence need not be backed by any capital. A loan to a multilateral agency, such as the World Bank, carries a 20 per cent risk weighting and hence requires only partial capital backing. Loans to commercial enterprises or to non-Organisation for Economic Co-operation for Development (OECD) Governments carry a 100 per cent risk weighting, requiring the full capital backing. A higher risk rating means a higher capital cost for the bank. The members of the Bank for International Settlements have not yet stated what the risk weighting will be for developing country loans that carry partial multilateral or bilateral official guarantees. A rapid decision will make it easier for banks to measure the impact of any debt-reduction package. A lower risk weighting to collateralized debt will encourage banks to participate in debt-reduction schemes.

F. Enhancing the secondary market

62. The secondary market holds clear benefits for debtors because secondary market discounts are deeper than what has so far been achieved through negotiated debt reduction. Debt/equity swaps by themselves cannot solve the problem, as explained earlier. But such transactions can be very helpful at the margins. Debtor countries can enhance the attraction of the secondary market for banks by increasing investment opportunities in their own economies. Buyers of debt paper have to have some use for the local currency they acquire at the end of the process.

63. Selling off shares in public enterprises has the advantage of limiting the inflationary impact of debt/equity transactions, which is problematic when shares in an existing private sector company are swapped. But foreign banks that hold most of the debt are often uninterested or restrained by home country regulations from owning interests in non-financial concerns. Debt/equity swaps involving such enterprises therefore usually involve a third party, which makes the exchange cumbersome and also limits the ultimate benefit to the debtor Government. (The third party wants to share the discount.)

64. Debtors could encourage more direct debt/equity swaps by opening their domestic markets to participation by foreign banks and allowing banks to convert their foreign currency claims into local currency denominations devoted to capitalizing local banking operations. At least some of the larger transnational banks might be interested in this kind of investment. However, structuring a beneficial debt-equity conversion programme requires considerable administrative skill and attention to details. 27/ Creditor countries could also review their regulations, including those concerning ownership of interests by banks in non-financial concerns to facilitate direct debt/equity swaps.

G. Capital flight

65. Banks point to massive debtor-country assets held abroad as a justification for the assertion that debtors do not really need much debt reduction. And they often criticize countries for pursuing policies that discourage local investment. But a number of banks facilitate capital flight by offering attractive, confidential investments of the funds once these have left the debtor country.

66. It is recognized that debtor countries have their own responsibility to implement policies which discourage flight of capital, and that citizens who have chosen to keep their savings abroad can hardly be compelled to repatriate their funds. But it might be possible for a debtor Government to ask foreign banks to identify the accounts of its residents so that the interest earnings on that money can be taxed by the home country. Debtor countries could also ask the United States and other Governments to stop issuing bearer bonds that help foreign investors to remain anonymous. The United States and some other developed countries tax the world-wide income of their residents, including interest income on foreign bank accounts. Developing countries could do the same, provided they can identify the holdings. Resulting tax revenues might help to ease the fiscal deficits of debtor Governments, so that flight capital would make at least a partial contribution towards the country's economic recovery. Bank disclosure would require the full co-operation of the major financial centres, otherwise flight capital would simply move out of banks that co-operate to banks that do not. A co-operative effort is already under way by the group of seven industrialized countries to identify and monitor large financial transfers across national borders to impede the movement of drug money. Tracking flight capital would not add significantly to the reporting burden on banks.

H. Institutional arrangements

67. Many proposals made so far for the solution to the debt problem suggest the creation of a new institutional arrangement in the form of an international debt facility. 28/ Among the arguments advanced in support of establishing such a facility are that it would replace the complicated ad hoc process of co-ordinating debt relief by many creditors under the umbrella of a single institution; it could introduce greater consistency in the international treatment of the debt problem, in contrast to the present situation in which all debtor countries are not generally able to obtain similar concessions from the creditors; and it could ensure more orderly relationships between creditors and debtors by replacing contractual obligations that exceeded repayment capacities of debtor countries with obligations carrying lower default risk.

68. A major concern relates to the resource requirements for establishing a new debt facility. It has been estimated that the budgetary impact of its establishment would be in the order of $10 billion. This requirement of official resources is considered small relative to the prospective financing requirement of the Brady plan if it were to provide any significant debt relief. 29/ The international community could give serious consideration to the establishment of such a facility.

CONCLUSION

69. The Brady plan has set debt policy on a rational, but slow track towards a solution of the problem. Its success is likely to be limited unless creditor Governments and other official entities exercise firm leadership over the banking community and/or commit more resources to the debt-reduction process. Moreover, additional steps will need to be taken by all parties, including debtor countries, to bring about any significant reduction in debt in the near future. Some of these steps have been outlined above.

70. There are, no doubt, problems in bringing about a quick solution to the debt problem. Some of these relate to the availability of official resources to support debt/debt-service reduction, the "free rider" problem, in that some banks may not participate in debt reduction efforts in the hope that they could gain from the participation of others. There is also the issue of "moral hazards", in that debt reduction may weaken debtor countries' incentives to adopt the required structural adjustment policies. These problems are not insoluble and, in fact, have been addressed to some extent in the agreements negotiated so far. Nevertheless, additional measures are called for, because without swift and deep debt reduction, the 1990s will be another lost decade for the debtor countries.

Notes

1/ See Official Records of the Economic and Social Council, Supplement No. 10 (E/1989/28), chap. I.

2/ Report of the Secretary-General on transnational banks in developing countries (E/C.10/1989/13). The part of that report dealing with external indebtedness is also contained in Transnational Corporations and International Economic Relations: Recent Developments and Selected Issues, UNCTC Current Studies, Series A, No. 11, United Nations publication, Sales No. 89.II.A.15, pp. 33-44.

3/ For an elaboration of this point, see UNCTC/ECLAC Joint Unit on Transnational Corporations, Transnational Bank Behaviour and the International Debt Crisis (forthcoming).

4/ Bank for International Settlements, 59th Annual Report (Basle, 1989), p. 131.

5/ World Bank, Quarterly Review (June 1989), p. 13.

6/ Organisation for Economic Co-operation for Development, "East-West trade and financial relations: developments in 1987-1988 and future prospects", Financial Market Trends, Number 42 (February 1989), pp. 25-27.

7/ See Tony Kollick and Matthew Martin, "African debt: the search for solutions", United Nations Africa Recovery Programmme Briefing Paper, No. 1 (June 1989).

8/ For further details, see the report of the Secretary-General on external debt crisis and development (A/44/628) and the report of the Secretary-General on transnational banks in developing countries (E/C.10/1989/13).

9/ For a brief description of these proposals, see World Economic Survey, 1989 (United Nations publication, Sales No. E.89.II.C.1), pp. 69-70.

10/ For greater details, see World Economic Survey, 1989 ..., pp. 69-70, and The World Bank, Quarterly Review, (March 1989), p. 1.

11/ The World Bank, World Debt Tables, 1989-1990, vol. 1, p. 3.

12/ World Economic Survey, 1989 ..., p. 78.

13/ Trade and Development Report, 1989 (United Nations publication, Sales No. E.89.II.D.14), pp. 47-48.

14/ Bank for International Settlements, Annual Report, 1989, p. 131.

15/ World Bank, Quarterly Review (June 1989), pp. 8-9.

16/ World Debt Tables ..., p. 15.

Notes (continued)

17/ World Economic Survey, 1989 ..., p. 78.

18/ Trade and Development Report, 1988 (United Nations publication, Sales No. E.88.II.D.8), p. 116.

19/ The methodology of the estimation is as follows: taking 1988 as the base year, for each of these countries exports of goods and services are set to grow at the rate of 5 per cent per annum over a period of three years. Twenty per cent of the exports of the terminal year thus estimated is considered to be the interest to be paid in the terminal year. The interest due in the terminal year is capitalized by applying a 10 per cent rate to estimate the volume of debt in the terminal year. The volume of debt of the terminal year is deducted from that in 1988 to estimate the required reduction of debt.

20/ Latin American Review, vol. 10, No. 2 (New York, 1989), p. 23.

21/ The New York Times, 27 July 1989.

22/ See William R. Cline, "At last, a plan that reduces the pain", and Shafiqul Islam, "It's a bad deal for the model debtor", New York Times, 6 August 1989.

23/ World Debt Tables ..., p. 28.

24/ Ibid., p. 53.

25/ Jeffrey Sachs, "Making the Brady plan work", Foreign Affairs, vol. 68 (Summer 1989), pp. 98-99.

26/ For a detailed comparison of national regulatory practices, see Price Waterhouse, "Regulatory accounting and tax aspects for sovereign risk lending" (September 1989), mimeo., and Jonathan Hay and Michel H. Bouchet, The Tax, Accounting, and Regulatory Treatment of Sovereign Debt (Washington, D.C., The World Bank, 1989).

27/ United Nations, Debt-Equity Conversions: A Guide for Decision Makers (forthcoming).

28/ For a detailed discussion of how such a facility could operate and its various pros and cons, see World Economic Survey, 1989 ..., pp. 76-78.

29/ Ibid., p. 77.

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ROLE OF TRANSNATIONAL CORPORATIONS IN SERVICES, INCLUDING TRANSBORDER DATA FLOWS: ROLE OF TRANSNATIONAL CORPORATIONS IN OTHER SERVICES

Transnational service corporations and the Uruguay Round

Report of the Secretary-General

SUMMARY

Foreign-direct-investment issues are related to the negotiations on trade in services in the Uruguay Round of multilateral trade negotiations mainly because many services are not independently transportable and their delivery abroad requires the movement of factors of production, including capital and/or labour. Accordingly, issues relating to foreign direct investment have surfaced during the discussions by the Group of Negotiations on Services (GNS) of a definition of trade in services, of the coverage of sectors and transactions by a framework, and of the concepts and rules for trade in services. They are included in the proposals submitted by a number of countries and in the declaration adopted by ministers at the time of the mid-term review of the Uruguay Round. The question of the distinction between trade, foreign direct investment and other modes of delivery for conceptual and statistical purposes is therefore an important one. As far as foreign direct investment is concerned, the role and impact of transnational corporations and the relevance of key negotiating principles in the sectors or industries that a services agreement would cover are of considerable interest.

* E/C.10/1990/1.

especially for host developing countries. In some of the six industries - telecommunications, construction, transport, tourism, financial and professional services - selected by the GNS for testing the applicability of the concepts, principles and rules included in the mid-term declaration transnational corporations play an important role in delivering services to foreign markets through equity or non-equity affiliates located abroad.

Not surprisingly, concepts applicable to foreign direct investment have been increasingly used in the context of trade in services. Hence international instruments dealing with international investment are of considerable relevance for the negotiations. Among those instruments, the draft code of conduct on transnational corporations is of particular significance.

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INTRODUCTION

1. The present report focuses on foreign-direct-investment issues related to the negotiations on trade in services in the Uruguay Round of multilateral trade negotiations. Section I outlines the principal modes of international delivery of services and examines them from the point of view of the definitions of cross-border transactions and foreign direct investment used by international organizations and major home and host countries. Section II highlights some aspects of the role of foreign direct investment and transnational corporations in those service industries which have been examined by the GNS and the implications and applicability of key concepts and principles for trade in those industries. Section III discusses briefly the relevance of the draft code of conduct on transnational corporations to the services negotiations, an issue examined further in document E/C.10/1990/5. A summary of the current status of services negotiations within the Group of Negotiations on Services (GNS) and its relevance to the work of the Commission on Transnational Corporations is provided below.

2. The Ministerial Declaration on the Uruguay Round, adopted at Punta del Este in 1986, launched a new round of multilateral trade negotiations which also covers, for the first time, negotiations on trade in services aimed at the establishment of a multilateral framework of principles and rules for trade in services, including the elaboration of possible disciplines for individual industries. Work on such a framework is to be undertaken "with a view to expansion of such trade under conditions of transparency and progressive liberalization and as a means of promoting economic growth of all trading partners and the development of developing countries. Such framework shall respect the policy objectives of national laws and regulations applying to services and shall take into account the work of relevant international organizations". 1/

3. The task of drafting a services framework was given to the Group of Negotiations on Services, which was established separately from other negotiating groups. The initial work of the Group centred on the following elements: definitional and statistical issues; broad concepts on which principles and rules for trade in services, including possible disciplines for individual industries, might be based; coverage of the multilateral framework for trade in services; existing international disciplines and arrangements; and measures and practices contributing to or limiting the expansion of trade in services, including specifically any barriers perceived by individual participants, to which the conditions of transparency and progressive liberalization might be applicable. A large number of proposals submitted by participating countries were discussed.

4. At the end of the first phase of the negotiations, the Group agreed on a number of concepts, principles and rules which were included in the declaration adopted at the mid-term review meeting in April 1989 as the basis for further work by the Group. While continuing its work on the elaboration of elements of a future framework, GNS devoted several meetings in 1989 to the examination of possible implications and the applicability of concepts, principles and rules for particular industries and specific transactions. The industries tested were

telecommunications, construction, transportation, tourism and professional and financial services (including insurance).

5. Foreign-direct-investment issues had entered into the discussions before the negotiations on services began, the reason being that many services are not transportable and their delivery abroad requires the movement of factors of production, namely, capital and/or labour. These issues surfaced during the discussions of a definition of trade in services, the coverage of industries and transactions by a framework and concepts and rules for trade in services. They were included in the proposals submitted by a number of countries and in the report of the Group prepared for the mid-term review meeting. They are also reflected in the mid-term review declaration, which recognizes that the multilateral framework may include "trade in services involving cross-border movement of services, cross-border movement of consumers, and cross-border movement of factors of production where such movement is essential to suppliers". 2/

I. INTERNATIONAL TRANSACTIONS IN SERVICES

6. Services may be delivered to foreign markets through a variety of modes. They comprise the cross-border movement of services and information, the movement of persons (whether as providers or as customers), foreign affiliates in which the service provider has equity participation, licensing or other non-equity mechanisms and commercial presence including sales or representative offices. These are analytical distinctions which are important for statistical purposes and, most important, for policy purposes, as different policy régimes are associated with different modes of delivery. At the same time, for service providers, they represent a continuum of means, some of which might be complementary, by which services can be delivered to foreign markets. This has been recognized by the Uruguay Round negotiators on services, who have stated, in the context of the principle of market access, that consistent with other provisions of the multilateral framework and in accordance with the definition of trade in services, "foreign services may be supplied according to the preferred mode of delivery". 3/ The present section outlines the various modes of delivery and discusses how the two major ones - cross-border transactions and foreign direct investment - have been defined for different statistical purposes and how they have been approached by GNS.

A. Modes of international delivery of services

1. Cross-border movement of services and information

7. The cross-border delivery of services is the only mode of delivery which has the traditional attributes of trade in goods: services are provided by a producer in the exporting country to a consumer in the importing country. In contrast to goods, however, only services embodied in goods (e.g., software disks or video cassettes) or those whose value-added can be put on paper (consultancy reports or architectural drawings) actually cross borders independently of producers. In most

other cases it would be difficult to see the physical movement of a service because most services are intangible and non-storable.

8. Other examples of this mode of delivery involve the use of telecommunication technologies to transmit information or other work products from a producer to a consumer. Although this mode of delivery - through transborder data flows - now appears to account for a small share of international transactions in services, it can be expected to grow in importance as the data technologies and data services that permit them to take place become more economical and more widely applied. Data technologies and data services permit services produced in one place to be consumed in another place; in other words, the unity of time and space is no longer required to produce and consume services, especially information-intensive services. As a result, the tradability of such services as banking, insurance, legal, architectural, engineering and consulting services, software and other data services increases. 4/ All these are information-intensive industries; and information is a service product which can be transported via telecommunication channels. Information flows can also support or supplement services delivered by other means, for example computer reservation systems support international lodging or air transportation services. Transnational computer-communication systems are already widely used within corporate systems of transnational corporations. The new technologies have already resulted in increased intra-firm flows of services, although it is difficult to measure these flows statistically.

2. Movement of persons

9. In many cases, for an international service transaction to take place, persons have to cross international borders either to purchase or to supply services. Travel, one of the four major services items in the balance of payments, falls under services which require the consumer to move to the location of the provider. Other examples, usually not isolated in data collections, include educational expenses of foreign students or medical services purchased by foreign patients.

10. The movement of the provider to the location of the consumer is essential for the international delivery of construction and consulting services, professional and domestic services, and installation, training and maintenance or repair services provided in connection with the sale of equipment abroad. The provider may be a person or a group of employees of a represented or established company, or an individual staying abroad for the duration of an assignment or contract or for a longer time. Providers may, for example, be unskilled construction workers brought to an importing country for a specific project undertaken by their company or highly skilled professionals (managers or lawyers) working for a foreign company or on an individual contract. In each case, the issue is not whether service providers are skilled or unskilled, but rather that they are abroad for a specific purpose and typically for a limited time.

11. A separate issue related to this mode of delivery concerns movement of labour for a limited or an indefinite period of time which does not involve the delivery of any specific services except for the services of foreign labour. International transactions which result from work of persons established abroad are reflected in

the remittances of their income. In the balance of payments, they are recorded not under any identifiable service item but as "labour income", "migrant transfers", "workers' remittances" and "other private transfers". 5/ However, services provided by highly skilled professionals (e.g., engineers) can be included in the professional service concerned.

3. Delivery through foreign affiliates

12. In many cases, cross-border transactions are not the optimal mode of delivery for a service or, for all practical purposes, they are not possible. The need for close communication and interaction between the provider and the customer makes it more efficient, if not necessary, for the service to be produced by an affiliate located in the same country (or even the same locality) as the consumer. For example, hotel, retail banking or car-rental services require that the provider establish facilities in the country of the customer. Often, proximity to the customer enables a provider to respond more efficiently and effectively, and with a greater degree of sensitivity, to a purchaser's needs, than could an entity located in a foreign country. For example, the maintenance of computers or office equipment would almost always be performed by an entity resident in the same country as the equipment. In some cases, government regulations may even prohibit the provision of services by non-residents. For these reasons, services are often delivered abroad through foreign affiliates in which the service provider has a controlling interest, that is, through foreign direct investment.

4. Delivery through licensing and other non-equity mechanisms

13. Sometimes a company will not attempt to sell in foreign markets either directly or through foreign affiliates, but may still be able to play a role in those markets through the sale or licensing of intangible assets or through other non-equity forms of co-operation or interaction with foreign firms. Many of these may involve an element of control over the foreign firm as well. In manufacturing, such cases are typified by the licensing of industrial processes or trademarks. For services, they are typified by business format franchises and professional associations. In the case of the former, franchise fees may reflect payments for a combination of services (e.g., consulting and advertising) and intangible assets (e.g., use of operating manuals or of a brand name or trademark).

14. For professions, such as law or accounting, firms in different countries may have professional ties that, from the standpoint of operations, may be very similar to foreign direct investment. For example, information may be shared, and efforts may be made to rationalize production on a global scale by referring business to the entity that can provide it in the most effective and economical manner. The entities in different countries may even operate under the same company name. In addition, international flows of funds such as referral fees and shares of revenues for jointly provided services may take place among these entities.

5. Commercial presence

15. Cross-border transactions sometimes require the establishment in another country of entities that do not conduct activities for their own account, but only for the account of their owner; they may be regarded as a part of the infrastructure of a transnational corporation and categorized as commercial presence. For example, an airline or ship operator may establish a ticket office or a terminal or port facility in a foreign country in order to service its own operations, or a foreign sales office may be established to book sales for the account of the entity in the home country or to engage in representational kinds of activities on its behalf. Similarly, a telecommunications firm may require support facilities, such as ground stations, in foreign locations to conduct its business, although these facilities themselves do not have sales. Or a bank may establish a representative office in a country in which it cannot, or chooses not to, conduct business directly. Sometimes these entities may also obtain significant revenues from provision of services to unaffiliated parties.

B. Definitional issues related to cross-border transactions

16. The peculiar nature of services makes it difficult to agree on a definition of trade in services. Standards applied to goods are not very useful in this respect because only a few services cross borders in the same way as goods do when they are subject to international trade. The definition of cross-border transactions used for balance-of-payments purposes helps to categorize some modes of delivery of services as falling under those transactions which are usually considered trade in services.

17. Cross-border transactions are defined in the balance of payments as transactions between natural or legal persons residing in different countries. By this definition, only the cross-border movement of services and information and travel of a consumer to a provider abroad can be categorized as cross-border services transactions. Other modes of delivery do not lend themselves to easy categorization as either cross-border or foreign direct investment-related transactions in services per se.

18. Services delivered abroad by a provider, staying there temporarily or established, present the greatest difficulty in defining the boundary line between cross-border transactions and the movement of the factors of production (including foreign direct investment) as the mode of services delivery. A classification of provider movements as "trade" depends, first, on whether it takes place within a corporate structure; secondly, on whether the movements of persons are accompanied by a relocation of other corporate assets; thirdly, on the duration of stay abroad; and, finally, on the definition of services. The provision of the services of skilled professionals to clients in other countries is usually categorized as a cross-border services transaction. But when professionals move abroad (as managers do) within a corporate structure, their services may not be recorded as a separate international service transaction. Remittances of workers remaining abroad and providing services of labour are singled out in the balance of payments under the separate items measuring transactions related to movement of labour which are not

services transactions. But if workers are a part of a company which also relocated abroad capital equipment, know-how and technology, they are not considered as immigrants by the host country. In other words, they are not considered as delivering a pure labour service but a specific service (e.g., construction). When providers of services consist of a group of employees of a company which is represented or established, the resulting transaction may be classified as cross-border or foreign direct investment-related, depending on the duration of the contract or assignment. As discussed later, a transaction would generally be considered cross-border if the producer's foreign presence was of limited duration (e.g., less than one year) or if there were conceptual or practical problems in accounting for it as a separate business enterprise.

19. The delivery of services through foreign affiliates is excluded from cross-border transactions in services because foreign affiliates are considered by balance-of-payments compilers as residents of the country where they are located, rather than of the country of their parent firms or owners. Their local sales are not cross-border transactions, because they do not result in changes in the host country's claims on and liabilities to the rest of the world and thus are not recorded in balance-of-payments accounts. The activities of foreign affiliates may, of course, give rise to transactions that are international, including flows of capital, exports, imports or the foreign owners' share in the affiliate's net income.

20. From the point of view of the balance-of-payments definition of cross-border transactions, the delivery of services through non-equity mechanisms and offices belongs to a grey area which does not fall uniformly either under cross-border services transactions or under foreign direct investment-related delivery. In section C below these and other cases from the point of view of existing definitions of foreign direct investment will be examined.

C. Definitional issues related to foreign direct investment

21. Current balance-of-payments guidelines neither clearly define trade nor cross-border transactions in services. The definition of foreign direct investment is clearer, although not uniformly used by countries. Between those two modes of the international delivery of services exists, therefore, a grey area of transactions which are classified differently, depending on convention, purpose or convenience. The grey area cases have been identified above. They include transactions related to temporary presence abroad as well as delivery through non-equity mechanisms and offices and agencies. The present section examines these modes of delivery from the point of view of the definitions of foreign direct investment used by international organizations and major home and host countries. Section D below contains a discussion on how this problem has been tackled by the Group of Negotiations on Services.

22. Among the many conceptual issues concerning the definition and measurement of foreign direct investment, two are of particular relevance to international transactions in services. First, it is important to distinguish direct from portfolio investment and to categorize the delivery of services through non-equity

arrangements and offices as either foreign direct investment or trade. Secondly, in the case of transactions requiring a deployment by a provider of machinery, equipment and employees abroad, the duration of operations is important in order to distinguish between foreign direct investment and cross-border transactions.

1. Equity participation

23. As regards the first issue, equity participation, there has been a clear tendency towards lowering the cut-off point distinguishing foreign direct investment from other types of investment. This tendency reflects the growing recognition of the fact that, especially for large corporations, a small share in the equity of a foreign enterprise may ensure a decisive influence in the management of this enterprise. Moreover, control may be achieved not only through the investment of capital abroad but also through non-equity, contractual arrangements.

24. The most widely used definition of foreign direct investment - that of the International Monetary Fund (IMF), which provides international guidelines for countries in compiling balance-of-payments statistics - does not specify a minimum ownership percentage for the foreign investors. According to the most recent edition of the IMF Balance of Payments Manual, "direct investment refers to investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor's purpose being to have an effective voice in the management of the enterprise". 6/ The survey of country practices conducted by IMF shows that most countries rely on minimum percentages of foreign ownership which range from at least 5 per cent to more than 50 per cent, country by country, and sometimes case by case within the same country. In the absence of foreign ownership, only a few countries base their identification of foreign affiliates on other elements. 7/

25. The Organisation for Economic Co-operation and Development (OECD) has established a "benchmark definition" of direct investment in order to increase the comparability of relevant data. Given the dominance of the OECD countries in world direct investment, this definition has been quite influential. It recommends that the following be considered foreign direct investment: enterprises in which a single foreign investor controls more than 10 per cent of the ordinary shares or voting power of the enterprise. Cases with less than 10 per cent (or none) of the equity participation should also be included, provided that the investor has an effective voice in the management of the enterprise. 8/ To identify these cases, OECD recommends the examination of a number of other factors, including whether there is representation of the foreign investor on the board of directors, participation in policy-making, existence of intercompany transactions, exchange of managerial personnel, flows of technical information and provision of loans at other than market rates.

26. The United States of America has also adopted a set of criteria that consider factors other than equity holding in determining whether a foreign operation constitutes foreign direct investment. 9/ If a United States national's foreign activity or operation is incorporated abroad, it is a foreign affiliate. In the

absence of incorporation, a foreign activity or operation would generally be considered a foreign affiliate if it paid foreign income taxes; had a substantial physical presence abroad; maintained separate financial records; took title to the goods it sold and received revenues therefrom; or received funds for its own account from customers for services it performed.

27. These definitions foresee the possibility that foreign direct investment can exist without ownership of voting shares. Therefore, non-equity arrangements - which are particularly popular in delivering services abroad - would be considered foreign direct investment as long as they granted control over the foreign establishment to a foreign natural or legal person. And, indeed, such arrangements as professional associations, business format franchises or management contracts may result in a lasting interest or effective voice in the management of affiliated enterprises. However, the implementation of the recommendation to include zero equity cases in foreign direct investment is difficult owing to the practical problems of capturing such cases statistically. The stock of foreign direct investment is measured in terms of equity and debt between parents and affiliates, which is a visible measure that does not exist in the case of non-equity forms. Furthermore, direct investment income is defined as a return on equity and debt investment, as distinct from income on non-financial intangible assets (connected with certain non-equity forms), which falls under the "royalties and license fees" heading.

2. Duration of operations

28. The duration of foreign operations is of particular importance in construction, where the distinction between cross-border transactions and sales through foreign affiliates is difficult to make. Neither the IMF nor the OECD definition provides detailed guidance as to the minimum duration of a foreign operation which would qualify it as foreign enterprise with foreign direct investment. The IMF Balance of Payments Manual does make a recommendation for the installation of equipment that can be extended by analogy to other types of services. The recommendation is that, if the installation is carried out in a period of less than one year by the employees of the entity selling the equipment, then the transaction is to be considered cross-border (i.e., between residents and non-residents); but if it is to take longer, and the work is to be done primarily by workers from the country in which the equipment is to be located, then the transaction should be attributed to a direct investment enterprise. 10/ The OECD benchmark definition makes an exception to the one-year rule in the case of construction, stating that "when a construction enterprise directly undertakes work abroad, even if the work takes less than one year, this should be regarded as being done through a national direct investment enterprise". 11/ However, few, if any, countries, actually follow this practice; instead, most include the revenues from construction in the current account as a services item, "earnings on construction work abroad".

29. The definitions related to foreign-direct-investment data collection throw some light on the treatment of such modes of delivery of services abroad as non-equity arrangements, offices, agencies or operations of limited duration.

However, even though the long-term trend has been towards the inclusion of those forms in foreign direct investment, this has not yet become the prevailing practice in most countries including major home/host countries for foreign direct investment. Other definitions found in, for example, bilateral investment treaties are not helpful in resolving the issue of borderline cases because they usually cover all kinds of international investment and therefore do not make a distinction between direct and portfolio investment.

D. Approach of the Group of Negotiations on Services

30. The mandate for negotiations on services agreed upon in the Ministerial Declaration on the Uruguay Round calls for a multilateral framework of principles and rules for trade in services, without specifying the types of transactions which the framework would cover. In the absence of a generally accepted definition of trade in services and in the light of the peculiar nature of international transactions in services, one of the major tasks for the GNS negotiators is to agree upon the scope of transactions and service industries which should be covered by an agreement. Two views of the importance of the definition of trade for the negotiations have emerged. One is that an early agreement on definition is crucial for further negotiations because it would allow the determination of principles and rules and an overall balance of advantages. The other is that the generic definition of trade is not essential: negotiating the list of various services and transactions of interest for the participating countries would be a more practical and flexible way to tackle the problem of coverage. Those in favour of this view argue that it would then be possible to take account of both the diversity of the service industries and the various forms of delivery of services. In some industries only the cross-border sales of services would be covered, while in others, services requiring the movement of factors of production would be included. 12/

31. The proposals submitted during the initial phase of negotiations represented the divergent views of the participants on the scope of trade in services. They included the whole range of the possible modes of delivery of services from cross-border movement of services and consumers, through the residence abroad of labour and providers of labour-intensive and professional services, to the movement of production factors including the facility for foreign service providers to establish themselves in the host country. Accordingly, these divergent definitions of trade have led to a variety of proposals concerning concepts, principles and rules for the future framework. For instance, the national treatment concept includes, on the one hand, the proposal that this treatment be accorded to foreign service suppliers and, on the other, that it be limited to cross-border services and labour and exclude foreign direct investment. Individual country proposals concerning market access cover also all possible modes of delivery of services.

32. At the mid-term review of the Uruguay Round negotiations, carried out at Montreal in December 1988, ministers of participating countries took note of the report of GNS to the Trade Negotiating Committee, which included the above divergent proposals concerning, inter alia, a definition of trade in services and related concepts, while not, however, prejudging or pre-empting the participants'

final position in any area of the negotiations. The declaration on negotiations on trade in services adopted at the Montreal meeting does not exclude any mode of delivery from the future framework. However, it attempts, in a general way, to narrow the criteria which might apply to the inclusion of certain types of transactions. More specifically, the ministers decided that:

> "Work on definition should proceed on the basis that the multilateral framework may include trade in services involving cross-border movement of services, cross-border movement of consumers, and cross-border movement of factors of production where such movement is essential to suppliers. However, this should be examined further in the light of, inter alia, the following:
>
> "(a) Cross-border movement of service and payment.
>
> "(b) Specificity of purpose.
>
> "(c) Discreteness of transactions.
>
> "(d) Limited duration." 13/

The declaration lists also concepts, principles and rules that are relevant to a multilateral framework. They are as follows: transparency; progressive liberalization; national treatment; non-discrimination; market access; increasing participation of developing countries; safeguards and exceptions; and the regulatory situation. Market access might mean, under certain conditions, that foreign services may be supplied according to the preferred mode of delivery. And national treatment may be accorded not only to services exports but also to exporters (providers).

33. As the Uruguay Round negotiations on services are still under way, it would be difficult to predict their outcome, especially with regard to the coverage of modes of transactions and industries. Some conclusions which are of relevance to the present report can, however, be drawn at this stage. First, issues related to the movement of factors of production, including foreign direct investment, constitute an important part of the negotiations. Secondly, while some developing countries emphasize the importance of labour movement for the delivery of services, developed countries focus on the importance of capital movement and related concepts. Thirdly, while recognizing various modes of delivery of services, the Montreal declaration initiated the search for the criteria limiting the inclusion of factor movements to cases where such movement is essential to suppliers. Fourthly, the negotiations have indicated a linkage between the definition of trade in services and industry coverage.

II. FOREIGN DIRECT INVESTMENT AND TRANSNATIONAL CORPORATIONS IN SELECTED SERVICE INDUSTRIES

34. The six industries selected by GNS for an examination of the implications and applicability of concepts, principles and rules cover services which are very important for the economies of both developed and developing countries. In most of

these industries, transnational corporations play an important role in international transactions through foreign direct investment, including equity and/or non-equity forms of participation in the host economy. This role is related to factors limiting the cross-border tradability of most of the service outputs concerned, as well as to other technological, economic and regulatory factors influencing transnational corporations' decisions regarding the location of production. 14/

A. Telecommunication services

1. Products

35. Telecommunication services are important, not only because they are a rapidly growing industry in both national and international contexts but because they provide the means by which a whole range of other services are traded. Telecommunication services per se comprise a wide range of products, including telephone, telex, facsimile, call-waiting, conference calling, video conferencing, automated calling, data transmission, dedicated digital circuits, integrated services digital networks (ISDN) and packet-switched data transmission. With the convergence of telecommunication and computer services, telecommunication products now include also on-line electronic data bases and information systems, interbank systems for electronic fund transfers, and messaging services such as electronic mail and electronic data interchanges. Although basic telecommunication services comprising traditional voice transmission services are produced and consumed in most countries today, the great bulk of the more sophisticated (or "enhanced") services are concentrated in the developed market economies.

2. Role of transnational corporations and impact on host developing countries

36. In most countries, whether basic telecommunication services are provided by the public or the private sector, foreign direct investment is typically not permitted because telecommunications is considered a strategic industry. But even this is changing as recent foreign investments in the telecommunications infrastructure of some countries indicate. In addition, foreign direct investment has an important role in two different contexts. One is the provision of basic telecommunications services in some countries where such services are not provided by a public monopoly, but by a private corporation, as in the case of some small economies, or in economies where deregulation is taking place. The second is the provision of certain value-added services in which foreign direct investment is expanding rapidly, especially through cross-investments within developed countries.

37. In cross-border transactions (over networks which transcend national boundaries), as well as in foreign direct investment, the principal participants are a variety of transnational corporations mostly based in the United Kingdom of Great Britain and Northern Ireland, the United States of America and a few other industrialized countries. They range from the former monopoly carriers of major industrialized countries and traditional providers of international

telecommunications services through globally active manufacturing companies, trading houses and banks to small niche companies which offer tailor-made services and specialized data-bases. Since many of this divergent group report their telecommunication activities under different headings related to their other activities, it is difficult to get a clear picture of the magnitude of transactions or affiliate activities involved.

38. Given the high costs and concentration of international telecommunication in a few providers, one of the most important areas of impact of interest to developing countries relates to the balance of payments. The direct impact can be expected to be negative for countries that import telecommunication services, as part of either cross-border trade or affiliates' operations. The indirect consequences, however, could be positive since access to up-to-date technical, juridical and trade data and telecommunication links to buyers can be expected to improve competitiveness and export capabilities.

3. Concepts and issues

39. The central concept in an international framework for telecommunication services is that of access to and use of the telecommunication networks of other countries, especially to deliver enhanced services. This includes the right to "connect", and may be extended by some providers to the right to install equipment and, where networks are unsophisticated, to establish networks. The issue relates to both establishment and non-establishment - in certain circumstances foreign providers or users may wish to have a right of establishment, while in other circumstances, they may wish to be able to provide services across borders. 15/

40. Once a telecommunication service or service provider has gained access to the market, the issue becomes one of fair and equitable, or national treatment. Where telecommunication services are provided by foreign affiliates, they are typically faced with a national (normally public) monopoly, which makes the full implementation of national treatment difficult. Traditionally, exceptions to national treatment grounded in national security have been accepted. In the case of developing countries, considerations related to development objectives may also have to be taken into account.

41. More generally, development considerations are vital in any consideration of a framework for international transactions in telecommunication services. The main concern relates to putting firms in developing countries in a position to compete with those from developed countries, at least in the long run. Among other things, this would require access by developing country firms to closed-user group networks (which are generally proprietory) in respect of which the Governments of countries having developed market economies may have to assume some obligations. Furthermore, some obligations would have to be assumed by foreign providers and users of telecommunication services, in order to obtain an overall balance of rights and responsibilities. Developmental contributions by transnational providers and users of services must, however, be supported by a strengthened telecommunication infrastructure in developing countries, requiring, in turn, a massive infusion of technical assistance.

B. Construction services

1. Products

42. The construction industry combines services with materials to produce tangible end-products in the form of structures (such as houses) and production facilities (such as factories) which in turn yield a stream of services to the final user. Construction design involves conceptual assessments, feasibility studies, designs for facilities and project plans. Construction implementation involves the procuring of finance and supplies, the mobilizing of labour and equipment, and the managing and carrying out of projects by unskilled labourers and skilled crafts-people in conjunction with architects and engineers.

2. Role of transnational corporations and impact on host developing countries

43. International activities in construction have proliferated during the past few decades, reflecting technological developments, the search for markets and the desire for risk minimization on the part of construction firms. To supply foreign markets, providers of construction services must necessarily move to where demanders are located. Judging from data for the United States, 40 per cent to 60 per cent of foreign revenues of construction firms are earned from affiliate sales, compared with direct exports or cross-border transactions as defined for balance-of-payments purposes. Equity investment by transnational corporations is, however, relatively limited. This reflects the fact that joint ventures, turnkey projects and other non-equity arrangements tend to be the preferred mode of participation, partly due to host country regulations, which sometimes require joint venture arrangements.

44. The international market for design as well as implementation services is dominated by large firms from industrialized countries. Firms from some countries such as Brazil and other Latin American countries, India, the Republic of Korea and Yugoslavia are, however, making their presence felt. The Republic of Korea accounted for over 10 per cent of foreign implementation contracts in the early 1980s, although its share declined to 1 per cent in 1988. 16/

45. Foreign direct investment in construction is relatively more important in developing host countries: nearly twice as many affiliates of the largest firms are located in developing countries as in industrial countries. In addition to contributing to the creation of the infrastructure for development which may not otherwise be available, activities of transnational corporations in construction can result in positive and/or negative impacts of various kinds on the host economy. These include employment and output effects which are likely to be positive if transnational corporations supplement local activities in the industry. Transnational construction corporations could also contribute to technology transfer through training and building up local knowledge and skills, although this would depend considerably upon the employment policies followed by transnational corporations and the opportunities provided for interaction between local employees and expatriate experts. The close ties between design and engineering firms and construction implementation firms may, however, result in

firms of the same nationality being favoured and host country firms being crowded out. Lastly, the inclusion of financing as an important element in the granting of awards may place developing country construction firms at a disadvantage relative to transnational corporations from industrialized countries.

3. Concepts and issues

46. The delivery of most construction services requires that factors of production move across national frontiers, often in the form of foreign direct investment. Market access to foreign providers can be impeded by measures relating to domestic content or participation in projects, procurement discrimination in favour of local engineers and firms, accreditation requirements for engineers, foreign investment restrictions and immigration rules and requirements. Any comprehensive framework for international transactions in construction services would thus need to consider a variety of approaches. For example, access to the market for the purpose of investment could differentiate between permanent and temporary presence, the former being on a renewable licence basis and the latter on a project- or bid-specific basis. Equity investments could be viewed as permanent presence, and non-equity investments as temporary. Similarly, entry of both skilled and unskilled labour could be approached by distinguishing between short-term or temporary entry and long-term entry with quotas being established, consistent with national immigration policies.

47. The concept of national treatment raises particular problems for developing countries in the case of the construction sector. First, since competition would favour developed countries on the basis of capabilities, it may be necessary to make allowances for providing domestic firms the opportunity to develop their competitive capacity vis-à-vis foreign firms. Secondly, most countries might find it difficult (for national defence and other reasons) to liberalize procurement policies favouring domestic suppliers. Finally, the principle of development promotion requires particular attention with respect to the construction sector. Given the significance of the industry for the development of infrastructure, measures would be required for strengthening the economic and technological capabilities of developing countries in construction, and increasing their participation in international transactions. These could involve set-asides and other preferential arrangements (at least in the short-run) as well as technical assistance and provision of access to new technologies, including measures to enhance technology transfer by transnational corporations.

C. Transport services

1. Products

48. Transportation is an infrastructural industry of crucial significance for both developed and developing countries. The products of the industry include air, maritime, road, rail and inland water transportation services for passengers and cargo. These services may be further subdivided according to type of carrier - for

example, scheduled or charter airline services, and liner or tramp shipping services.

2. Role of transnational corporations and impact on host developing countries

49. Transportation is a carefully regulated industry in both developed and developing countries owing, among other reasons, to considerations of national sovereignty and security which have led most countries to restrict severely foreign participation in domestic transport services. Nevertheless, international transportation activities have increased rapidly in recent years. International transactions in the major international transport industries - airlines and shipping - have, however, been typically cross-border rather than related to factor movements produced by the residents of one country and consumed (partly) by the residents of others. International transactions in air-transport services have generally involved only a limited degree of presence in foreign markets, due mainly to international market sharing arrangements and national regulations with respect to foreign participation in domestic air transport. The situation, however, is changing rapidly, partly as a result of deregulation and anticipated deregulation, especially in Europe, and there is a trend towards increased foreign direct investment and transnational corporation activity through mergers and acquisitions by airline firms of ownership shares in foreign airlines, as well as link-ups through common reservation systems. Furthermore, airline companies are involved in the provision of services abroad through maintenance contracts. In maritime transport, too, foreign direct investment for the purpose of service delivery has been relatively limited. However, international transactions in shipping services do involve, in addition to the commercial presence of transnational corporations in the form of an office or agent, foreign direct investment or the establishment of affiliates, sometimes undertaken in order for a firm to be able to operate as a national carrier or as a means of access to a national flag.

50. There is a significant degree of concentration in international transport services transactions. In air transport, large airlines based in North America and Western Europe generate approximately 70 per cent of traffic (international and domestic). However, the past decade has witnessed a shift in the regional distribution of scheduled traffic, with the combined shares of North America and Europe falling from 62 per cent to 57 per cent and that of Asia and the Pacific rising from 21 per cent to 29 per cent. In shipping, the high costs involved in developing competitive national capacities have made it difficult for non-traditional maritime countries and low-income countries to increase their participation and share of international markets. Developed market economies, led by Japan, France, Italy, the Federal Republic of Germany and the United States, accounted for 90 per cent of world exports of shipment in 1987. 17/

51. Information regarding the impact of transnational corporation activities in transport services on host developing countries is limited because of the limited extent of affiliate activities so far. The employment of local sales staff as well as a limited number of operational personnel, mostly in technical and managerial positions, in airlines and shipping sales offices and other kinds of affiliates is

likely to offer opportunities for acquisition of know-how and technology by local staff. It should be noted, however, that airline and shipping management and operation professionals are typically internationally mobile. Several developing country airlines, for example, started their operations with expatriate staff, replacing them as indigenous skills increased.

3. Concepts and issues

52. Market access in air transport is currently determined by bilateral arrangements which limit the routes to be served and the type and quantity of traffic that may be carried, and effectively preclude any form of trade other than cross-border transactions through the use of ownership clauses. More flexible and liberal arrangements than those prevailing might be necessary if market access is to be improved, including the possibility of access through the establishment of local affiliates, perhaps in the form of joint ventures. Furthermore, numerous ancillary factors relating to forms of payment, access to local distribution channels, ground-handling facilities and airport and airway-user charges, among others, can also affect the ability of airlines to gain access to a foreign market.

53. The application of the principles of national treatment as well as most-favoured-nation treatment raise special questions in international transport-service transactions. Existing widespread prohibitions of foreign carriers with respect to domestic transport may need to be re-examined, in relation to national treatment as well as market access principles, keeping in view the national security and development considerations which apply to transportation. Current international régimes - such as bilateral airline service agreements and cargo-sharing - may also need re-examination from the point of view of most-favoured-nation treatment.

54. The importance of transport services in economic development underscores the significance of the principle of increasing participation of developing countries. Measures to strengthen the capital and know-how available to the transportation industries of developing countries are crucial if domestic and international capacities of those countries are to be strengthened. Such measures could include technical and other assistance programmes (such as those provided through the International Civil Aviation Organization) in regard to airport and aviation development, and technology transfer, training of shipboard and other personnel, and ship financing in the area of maritime transport.

D. Tourism services

1. Products

55. International tourism is defined as travel by a resident of one country to another country for recreational, business or other purposes. Tourism services are a highly heterogeneous mix of activities including hotel and other accommodation services, food and beverage services, transport, communications, financial services, business services, and recreation, cultural and sporting services. The

providers of these services can be divided into those who act as purveyors and those which are intermediaries. The most important among the former are hotels, restaurants, cruise lines and other recreational establishments. The major intermediaries include regularly scheduled and charter airlines, tour operators and travel agents.

2. Role of transnational corporations and impact on host developing countries

56. Tourism is one of the fastest growing industries and international tourism is among the leading service industries in world trade. The principal mode of delivery of international tourism services involves the cross-border movement of consumers; residents of one country travel to another and, once there, consume services (and goods) that are necessary for their stay. Those services, in turn, can be provided by either local or foreign suppliers, including transnational corporations. In the case of the latter, some kind of foreign direct investment or establishment abroad is necessary.

57. Transnational corporations with extensive technological, capital and management advantages play an important role in the development of international tourism and have often been responsible for launching viable tourism operations in developing countries. With a few exceptions, transnational tourism corporations are based in developed countries where there is a concentration of international tourism infrastructure and arrivals, and from where the majority of tourists originate. The extent and nature of their host country operations vary according to the type of tourism service involved. Forms of participation by hotel chains include equity interest, leasing arrangements, management contracts, franchise, or any combination of these arrangements. However, the most common form of delivery abroad of tourism services, particularly for transnational tourism corporations operating in developing countries, is the management contract.

58. Owing to the predominance of non-equity arrangements, the contribution of transnational tourism corporations to direct investment flows and stocks is limited. Transnational tourism corporations can, however, be quite important to the tourism industries of host developing countries and the benefits obtained from them. The benefits most commonly sought are foreign exchange earnings and employment generation. As regards the former, developing countries generally have a positive trade balance with respect to international tourism and, in some countries, such as those in the Caribbean, foreign exchange benefits from tourism are crucial. However, it should be noted that net foreign exchange income is often much lower than income figures may suggest. In general, it appears that the more developed the host country, the higher the proportion of tourism foreign exchange revenues retained by the local economy. As for employment, the bulk of the jobs created directly by tourism are for unskilled and low-level skilled employees. This is particularly beneficial to host developing countries with abundant labour. Equally important, however, are the technology and the upgrading of human resources that transnational tourism corporations can bring to host countries by elevating the skill-level, knowledge and management systems in host country affiliates through training programmes, shifting of personnel and other methods to install

standard operating procedures and levels of management effectiveness. These could, under appropriate conditions, be diffused to indigenous tourism enterprises.

59. Other important areas of impact include the generation of income and employment in local infrastructural, agricultural and manufacturing activities through linkage-effects, provided a sufficiently diversified economic structure exists. There may also, however, be negative impacts or costs to the host economy arising from the business practices of transnational corporations, such as reliance on specific (foreign) suppliers for food or other supplies.

3. Concepts and issues

60. Important restrictions affecting market access in the tourism industry, as noted by the GATT secretariat, include measures concerning foreign ownership of equity, limitations on remittances imposed by foreign exchange controls, limitations relating to the employment of foreign personnel and import and tax restrictions. However, although limitations on ownership and equity holdings and on the establishment of sales and representative offices restrict international tourism transactions in many countries, it should be recalled that transnational tourism corporations tend to prefer other modes of delivery. "Other considerations relevant to market access might cover the ability of foreign tourist enterprises to supply reservation services using telecommunication networks, market services under their own name, establish relationships with host country businesses to sell tourism services, have access to qualified staff and import essential products." 18/

61. National treatment in the tourism sector would involve issues relating to non-discriminatory treatment, for example elimination of discriminatory practices penalizing foreign airline carriers (higher landing fees, route access and the like) or limitations on transnational hotels with regard to granting of establishment licences, clientele or operations. However, these are not among the major types of barriers that have been observed, and many developing countries might be willing to do without them in order to attract tourism, foreign direct investment and transnational corporations.

E. Financial services

1. Products

62. The services produced by the financial services industry relate to commercial banking, investment banking and insurance. Commercial banking products comprise mainly consumer banking, which involves gathering deposits from, extending credit to, and making payments for, individuals. Corporate banking comprises these same services for institutional entities. And correspondent banking comprises interbank deposit and payment activities. Investment-banking products include a wide array of services involved in providing clients with direct access to capital markets such as arranging, underwriting or placing new debt or equity products in individual or institutional portfolios; trading and brokerage in existing debt and

equity securities and other assets; and investment management or the management of financial portfolios of clients.

63. The products of the insurance segment of the financial services industry include life and non-life insurance policies sold by retail companies directly to policy holders. Life insurance provides for payment in the event of death, injury or illness of the insured. Non-life insurance can be written to provide for payment in the event of virtually any calamity. In addition, the insurance industry also produces reinsurance services, which are essentially secondary insurance services provided to retail insurers.

2. Role of transnational corporations and impact on host developing countries

64. Financial services may be delivered to foreign markets through cross-border trade or through foreign direct investment. With the vastly enhanced telecommunication and computer links that now exist, especially among developed countries, a large number of capital and expertise-intensive activities can be undertaken without significant personal contact between the client and the provider, assuming capital movements are not controlled. A number of other services, however, require a high degree of personal contact. For these services, the establishment of local production facilities, especially through foreign direct investment, is the principal means of extending sales to foreign markets.

65. Financial services are considered strategic by Governments because of the central role they play in maintaining a stable, reliable currency and smoothly operating payments mechanism and in channelling investment, which determines the future structure and growth of an economy. Accordingly, they are subject to diverse and detailed national regulatory frameworks which, among other things, restrict the activities of foreign suppliers. Nevertheless, cross-border transactions as well as foreign direct investment in financial services are among the fastest growing service transactions world wide. These transactions are at present mostly concentrated in developed countries. The activities of transnational banks in developing countries remain largely limited in extent and confined to the traditional spheres of assisting in foreign-trade finance and participating, to some degree, in local markets. Recently, however, there have been signs of a possible expansion in new transnational bank operations in some developing countries as well. At the home country end, the most significant development in the 1980s is the shift in the national origin of transnational banks as reflected in the composition of the 100 largest banks, with a growth in the foreign affiliates of Japanese banks and a reduction of affiliates of banks from the United Kingdom and the United States.

66. The activities of transnational corporations in financial services affect host countries in a number of ways. Traditionally, the possibilities of adverse economic, distributional and monetary effects, arising on account of the difficulty of regulating transnational financial enterprises, have assumed precedence from the developing countries' point of view. Another negative impact that has been envisaged is the stifling of national financial service industries which are still

relatively underdeveloped. On the other side of the coin, greenfield foreign direct investment in financial services is likely to stimulate employment of skilled labour in the financial sector. Moreover, if transnational firms are more efficient than domestic financial companies, the costs of production in other industries could be lowered and international competitiveness enhanced. Finally, the transfer of soft technology by transnational banks and insurance companies to their local counterparts can, under appropriate conditions, be carried over to domestic financial institutions, with benefits to the economy as a whole.

3. Concepts and issues

67. Market access for foreign financial services and their providers is one of the most controversial issues in the area of international transactions in services. Restrictions affecting access include capital controls, entry barriers, ownership regulations and operating restrictions. National or non-discriminatory treatment vis-à-vis domestic competitors is an equally sensitive question since in many countries transnational corporations are subjected to more restrictive regulations than their local competitors.

68. From the point of view of developing countries, however, the principle of development promotion, including the increasing participation of developing countries, is likely to be the main consideration. This would mean incorporation of safeguards to avoid needlessly severe adjustment costs and adverse effects, as well as of positive measures for technology transfer and strengthening of domestic financial institutions, into any multilateral framework that is envisaged.

F. Professional services

1. Products

69. Professional services cover a range of activities involving individual providers with specialized knowledge, skills and responsibilities. A broad interpretation of professional services would include services rendered by the liberal professions (such as medicine and law), business or producer services (such as accountancy, auditing, architecture, engineering, advertising, compucer software and consultancy) and could extend to other activities involving a certain degree of specialization, such as automobile maintenance and repair, photographic services, laundry services, travel services, plumbing services, culinary services, carpentry, industrial cleaning, building maintenance and so forth. The provision of professional services nationally and internationally may involve firms and/or individuals, but individual expertise is the essential element. 19/

2. Role of transnational corporations and impact on host developing countries

70. It is generally believed that business services - services provided to business or producers - are of the greatest interest as far as international

transactions in professional services are concerned. Services such as accounting, management consulting and advertising are already as large as, if not larger than, many of the merchandise sectors in international trade. Transnational corporations play an important role in the international delivery of professional business services, due largely to the need for close and continuous contact between the provider and the client. Data for the United States confirm that business service firms serve foreign markets primarily through foreign affiliates, 20/ although modes of participation may take a variety of forms, including contractual arrangements and networks of associated partnerships, as well as equity participation.

71. Judging from data on the largest firms, transnational corporations from the United States are particularly strong in the markets for such professional business services as accounting, advertising, management consulting, legal and computer services. In some business services, firms from France, the Federal Republic of Germany, Japan and the United Kingdom also play an important role. Firms from some developing countries have begun making their presence noticeable in certain professional business services such as computer software, accounting and management consulting.

72. Because transactions in business services are conducted through foreign affiliates rather than cross-border trade, recipient or host countries can be affected directly in a number of ways. Available data on the foreign affiliates of selected United States business firms suggest that they generate considerable employment, sales and exports for host countries. 21/ More important, the efforts of transnational business service firms to provide uniform standards of quality and personalized service apparently involve significant training efforts. One accounting firm, for example, reported that during 1987 it provided an average of 170 classroom hours of training to each of its employees world wide. Such training obviously involves a transfer of skills and soft technology, with benefits extending beyond the firms concerned, owing to employment turnover. Forward linkages, which strengthen the capacity and competitiveness of producer-users, are another benefit for host countries. At the same time, intra-firm transactions and "restrictive" business practices of business service firms could result in adverse effects, especially for the balance of payments of host countries.

3. Concepts and issues

73. Any comprehensive framework for international transactions in professional services must address issues not only of pure cross-border trade but also those of movement of persons, right of practice, right of commercial presence and/or right of establishment. Given the diversity of professional services, it may be useful to distinguish between services that can be delivered through temporary relocation of factors of production and of the professionals performing the service (such as computer software and systems integration, market research, management consulting) and services for which a temporary relocation of factors is nearly impossible or opens up only a narrow window of opportunities (for example, licensed services such as accounting and legal services). The latter might be allowed a full-scale establishment presence while the former could be accorded the right to establish a

commercial presence to be used primarily by personnel seeking new business assignments and temporary professional staff. These rights of entry and establishment would have to be supplemented by extension of rights of practice for foreign professionals, and of residency permits and visas for foreign professionals. This raises sensitive issues relating to equivalencies of national diplomas, qualifications and standards on the one hand and immigration issues on the other.

74. Other concepts of particular relevance to professional services include those relating to national treatment and development promotion. As regards national treatment, individual countries might seek to exclude foreign suppliers of business services from certain classes of assignments, such as those involving national security, consumer protection or public and para-public sector procurement. Development promotion involves issues relating to increased access of developing countries to international professional services markets and the development of their competitive capacities. The former may require preferential programmes in public sector procurement of developed countries and in technical assistance projects of multilateral development agencies. As regards strengthening of domestic competitive capacity, some thought could be given to finding ways to increase developing countries' access to business-service technology. For example, the renewal of an establishment licence for a transnational corporation might be tied to the corporation's ability to demonstrate an adequate level of local training effort.

III. RELEVANCE OF THE CODE OF CONDUCT ON TRANSNATIONAL CORPORATIONS TO NEGOTIATIONS ON SERVICES

75. In attempting to establish an international framework for services, the Group of Negotiations on Services of the Uruguay Round of multilateral trade negotiations faces difficult conceptual problems, reflecting differences in policies and interests. These problems are aggravated by the lack of general concepts and principles applicable to trade in services which have not yet evolved, in contrast to those applicable to trade in goods and foreign direct investment. As a result, the current negotiating efforts have looked to existing conceptualizations concerning mainly trade in goods in order to draw on and adapt notions and principles for a framework for trade in services. Yet, while it is possible and useful to establish analogies between trade in services and trade in goods, important differences exist between the two kinds of trade. In particular, trade in goods has been considered, in economic theory and policy and in commercial practice, as a substitute for the flow of production factors. Trade in services, on the other hand, often involves such flows, thus resembling in significant ways the processes usually dealt with under the heading of foreign direct investment. Indeed, international transactions in many service industries involve a foreign investment aspect.

76. Concepts applicable to foreign direct investment have therefore been increasingly used in the context of trade in services, and international instruments dealing with international investment have become of considerable relevance for current negotiations on trade in services. Among those instruments,

the draft code of conduct on transnational corporations is of particular pertinence to GNS: not only because the code contains key concepts which overlap some of the concepts considered by GNS and which, therefore, might be of immediate usefulness in the negotiations on trade in services (other instruments, such as the OECD codes or bilateral investment treaties, also include similar concepts), but because the draft code is the only instrument that has been negotiated with the full participation of the developed, developing and socialist countries on a universal basis. As many provisions of the code have found consensus among all groups of countries, they may usefully complement any eventual framework agreement on trade in services in two major ways.

77. First, depending on the GNS approach to the definition and coverage of transactions and industries, issues covered by the draft code might find application in the discussions of the relevant provisions of the services framework. Such issues in the code as the right to regulate entry and establishment, fair and equitable treatment and national treatment have a direct relationship to the concepts contained in the Montreal declaration, namely market access and national treatment. The draft code has also made advances related to another concept considered important for a services framework, namely transparency of laws and regulations. In addition, the code is largely directed towards assisting the development of developing countries, thus dealing again with one of the crucial provisions of the future services framework.

78. Secondly, independent of the outcome of the Uruguay Round negotiations on services, the code, when adopted, would in any case be a useful complement to any framework for trade in services. It is not very likely that successful completion of the framework by GNS will cover all service transactions, especially all those related to foreign direct investment. That is where the code could fill a gap in dealing with transactions which are highly important in the international provision of services. The usefulness of the code in this respect stems not only from the fact that it deals extensively with all aspects of government regulations of foreign direct investment but, in addition, and as distinct from other frameworks, it also focuses on the rights and obligations of market operators in international service transactions, namely transnational corporations. By covering the rights and obligations of both Governments and transnational corporations, the code contains all the elements required for an effective framework for services transactions through equity and non-equity forms of foreign direct investment, some of which may not be covered by a future framework for trade in services.

79. In any event, the conclusion of the Uruguay Round services negotiations, scheduled for the end of 1990, is likely to increase the demand of developing countries for additional assistance in the area of services. If the approach adopted at the mid-term review meeting in Montreal is maintained in the future framework on trade in services, the attention of policy makers in developing countries will shift to the implications of the framework for developing countries, including the implications for their policies on foreign direct investment and the activities of transnational corporations in their service industries. The Commission on Transnational Corporations may therefore wish to pay attention to the links between the provisions of the emerging international framework on international transactions in services and foreign direct investment policies in

the services sector, as well as the technical co-operation needs associated with these links.

Notes

1/ "Ministerial Declaration on the Uruguay Round", GATT Focus, No. 41 (October 1986), p. 5.

2/ GATT, "Mid-term review agreements", News of the Uruguay Round of Multilateral Trade Negotiations, No. 27 (24 April 1989), p. 38.

3/ Ibid., p. 40.

4/ See Karl P. Sauvant, "The tradability of services", in World Bank and United Nations Centre on Transnational Corporations, Services in the World Economy (Washington and New York, 1990).

5/ Trade and Development Report, 1988 (United Nations publication, Sales No. E.88.II.D.8), part two, chap. III, sect. D.

6/ International Monetary Fund, Balance of Payments Manual (Washington, D.C., 1977), 4th ed., p. 136.

7/ Ibid., pp. 188-189.

8/ Organisation for Economic Co-operation and Development, "Detailed benchmark definition of foreign direct investment" (Paris, 1983), p. 7.

9/ See United States, Department of Commerce, Bureau of Economic Analysis, "Benchmark survey of selected services transactions with unaffiliated foreign persons, 1986" (form BE-20).

10/ International Monetary Fund, Balance of Payments Manual (Washington, D.C., 1977), 4th ed., p. 25.

11/ Organisation for Economic Co-operation and Development, "Detailed benchmark definition of foreign direct investment" (Paris, 1983), p. 7.

12/ GATT Focus, No. 57 (September/October 1988).

13/ See GATT, "Mid-term review agreements", News of the Uruguay Round of Multilateral Trade Negotiations, No. 27 (24 April 1989).

14/ For a more comprehensive discussion of the role of foreign direct investment in these industries, see The Activities of Transnational Corporations in Services: Papers Prepared for a Workshop for GNS Negotiators on the Activities of Transnational Corporations in Services, Montreux, 11-12 November 1989 (forthcoming United Nations publication).

15/ The right of non-establishment has become an issue because some countries require establishment as a pre-condition for the delivery of certain services. The policy of Brazil regarding data processing is a case in point. See Transborder Data Flows and Brazil (United Nations publication, Sales No. E.83.II.A.3), p. 150.

16/ Engineering News Record, various issues.

17/ GATT secretariat, "Trade in transport services" (MTN.GNS/W/60), p. 48.

18/ GATT secretariat, "Trade in tourism services" (MTN.GNS/W/61), p. 12.

19/ For a discussion of various aspects of international transactions in professional services, see Padma Mallampally, "Professional services", in World Bank and United Nations Centre on Transnational Corporations, Services in the World Economy (Washington and New York, 1990).

20/ Congress of the United States, Office of Technology Assessment, Trade in Services: Exports and Foreign Revenues (Washington, D.C., United States Government Printing Office, 1986).

21/ See Coalition of Service Industries, Inc., Company Operations in Developing Countries (Washington, D.C., April 1989).